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CIS

SAFE HARBOR LEASING: USABILITY BY SMALL BUSINESS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

SAFE HARBOR LEASING: USABILITY BY SMALL BUSINESS

MARCH 2, 1982

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CONTENTS

Page

Statement of Senators:
- D'Amato, Hon. Alfonse M., a U.S. Senator from the State of New York 1
- Nunn, Hon. Sam, a U.S. Senator from the State of Georgia 21
- Weicker, Hon. Lowell, Jr., a U.S. Senator from the State of Connecticut, and chairman, Senate Small Business Committee 3

Statement of:
- Chapoton, John E., Assistant Secretary for Tax Policy, Department of the Treasury, Washington, D.C 3
- Edwards, Harold, Jr., president and chairman of the board, O. M. Edwards Co., Inc., Syracuse, N.Y 96
- Finfer, Paul M., Beneficial Leasing Group, New York, N.Y 162
- Fitch, John, Jr., vice president, Government Relations, National Association of Wholesaler-Distributors, Washington, D.C 118
- Griffin, W. H., Griffin Lumber Co., Cordele, Ga 92
- Haddad, Robert, senior tax manager, Price Waterhouse, Boston, Mass 116
- Harris, Milton, president, Maryland National Leasing Corp., Towson, Md . 161
- Janeway, Eliot, president, Janeway Publishing Research Corp., New York, N.Y 76
- McCarthy, James B., vice president, General Business Services 115
- Mullenholz, John, Esq., National Farm and Power Equipment Dealers Association, Washington, D.C., accompanied by Thomas Huset, president, Association Credit Plans Inc 164
- Willaman, Owen, president, New York Air Brake Co., Watertown, N.Y 98

APPENDIX

Letter dated March 5, 1982, to Senator Lowell Weicker, Jr., chairman, Senate Small Business Committee, from Hilton Davis, vice president, Chamber of Commerce of the United States 229

Statement of Jonathan O. Moore, president, Air U.S 233

HEARING DATE

March 2, 1982:
- Morning session 1

SAFE HARBOR LEASING: USABILITY BY SMALL BUSINESS

TUESDAY, MARCH 2, 1982

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The committee met, pursuant to notice, at 9:10 a.m., in room 424, Russell Senate Office Building, Hon. Alfonse M. D'Amato (acting chairman of the committee) presiding.

Present: Senators D'Amato and Nunn.

Also present: Brian F. Hartman, financial analyst; Ed Zayas, economist, minority; Bruce Ray, legislative assistant; and Dorothy C. Olson, hearing clerk.

STATEMENT OF HON. ALFONSE D'AMATO, A U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'AMATO. The committee will come to order.

The Senate Committee on Small Business today will consider safe harbor leasing, particularly its usability by small business.

The U.S. economy is currently in a recession, a recession which is felt most deeply by the Nation's small businesses. Small businesses have traditionally been the backbone of the American economy. Now they are the frontline shock troops in our economic war.

Last year, as part of the program to restore economic health, Congress enacted the accelerated capital cost recovery system, ACRS, which allows faster depreciation of capital assets by businesses. This method of reducing corporate taxation frees up more money for productive investment.

Nearly 46 percent of U.S. corporations are already in such poor condition financially, however, that they have no taxable income. Thus faster tax writeoffs under ACRS are of no benefit. It is for this reason that Congress adopted safe harbor leasing as part of the total economic recovery package.

Leasing, to a great extent, equalizes the tax treatment of all businesses whether or not they have taxable income. The goal is to prevent both business failures and a torrent of mergers as healthy companies devour financially troubled firms in pursuit of their accumulated tax deductions and credits.

The leasing provision basically allows a corporation with no taxable income to sell its tax benefits to a more profitable firm, obtaining badly needed working capital in return. Both companies benefit, but the Federal Government foots the bill because tax writeoffs which would otherwise go unused will now be claimed.

The current estimated cost to the Federal Treasury of leasing is $33.6 billion by the end of fiscal 1986. This is slightly more than 20 percent of the estimated revenue loss from the entire ACRS system.

Given this impressive revenue loss, coupled with the unexpectedly high use of leasing since its enactment, many are now calling for its repeal. Advocates of repeal, however, ignore the fact that even though leasing may contribute to the deficit in the short run, in the long term it will result in the enhancement of Federal revenues as investment and productivity increase and the economy improves. Leasing spurs capital formation on a more equal basis across industries and promotes job creation and business expansion in all sectors of the American economy. Without leasing, some firms and entire industries will do well, while others will stagnate and die. This cannot be allowed.

This does not mean that safe harbor leasing, as enacted, is perfect. An important component of the U.S. business community was inadvertently omitted from the benefits of leasing when this legislation was passed. I refer of course to those companies, so-called closed corporations, where 50 percent or more of the stock is held by five or fewer shareholders. These companies are primarily small businesses, yet they represent a vital part of the American business community and should at least be on a par with larger firms in access to the tax benefits and methods of capital formation granted by Congress.

The answer that under current law closed corporations are permitted to be lessees, despite the fact that they are prohibited from being lessors, is insufficient. Small businesses are already greatly disadvantaged in a hostile economic environment. It would be unconscionable if Congress were to increase the hardships they face in the competitive marketplace.

By modifying section 465 of the Internal Revenue Code, the at-risk rules for closed corporations, we can give small businesses full access to the benefits of leasing. This program should not continue to be administered in a discriminatory fashion.

Today we will hear testimony on leasing and the access by small businesses to its benefits from several sources, including Assistant Secretary Chapoton, representatives of small business associations and small businessmen themselves.

We will also explore the use of leasing for mass transit. In 1981 the leasing provisions were used to finance the purchase of mass transit vehicles in 13 States to the tune of $160 million. In addition, another $74.5 million in 13 States is now pending. Leasing is vital if mass transit vehicles are to be financed at reasonable costs.

In closing, I would like to say that if for some reason safe harbor leasing is repealed, I hope that at the very least it is retained for mass commuting vehicles and for those transactions where at least one party, lessor or lessee, is a small business. The public purpose of these retentions would far outweigh any revenue loss which might result.

I have a statement by Senator Weicker which he has asked me to place into the record.

[The prepared statement of Senator Weicker follows:]

STATEMENT BY SENATOR LOWELL WEICKER, JR., CHAIRMAN, SENATE SMALL BUSINESS COMMITTEE

The purpose of today's hearing is to examine the safe harbor leasing provisions from a small business perspective. In recent years, lease financing has become a very important and often used means of raising capital for many small businesses. Lease financing, growing about 12-15 percent, is now estimated to be used in about one-third of all purchases of new industrial and business equipment.

In theory, the new safe harbor leasing provisions included in the economic recovery tax act of 1981 should make leasing even more attractive and make it easier for small companies to raise capital for new investments. It appears, however, that the "safe harbor" may not be generally available to small businesses either because transaction costs are too high or the "at risk" rules thats small companies are subject to destroy the economics of the transactions.

If it is true that small companies do not stand to benefit from the safe harbor provisions, then we must consider the $29 billion in revenue losses through 1986 that are associated with this provision and ask whether it does small business more harm than good. Certainly, if the safe harbor leasing provision is not repealed, then we should consider changes in the law to make the benefits of safe harbor leasing more available to small businesses.

Today the committee will hear from the administration, a noted economist, and the small business community. Today's hearing will put small business "on the record" with respect to safe harbor leasing and this record, the small business point of view, will be available to Congress when, and if, this provision is reconsidered.

Senator D'AMATO.. I would like to commend Senator Weicker, chairman of the Small Business Committee, for being the driving force behind these hearings today.

At this time let me call our first witness: Mr. John Chapoton, Assistant Secretary of the Treasury.

Mr. Chapoton, welcome.

STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, D.C.

Mr. CHAPOTON. Thank you, Mr. Chairman.

I am pleased to be here today to discuss the safe harbor leasing rules. I appreciate your opening comments, Mr. Chairman.

I did present testimony on the safe harbor leasing rules to the House Ways and Means Oversight Subcommittee and the Senate Finance Committee last December. I would appreciate a copy of that testimony being entered into the record of this proceeding.

Senator D'AMATO. That will be fine.

[The prepared statement of Mr. Chapoton follows:]

TREASURY NEWS
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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS
December 15, 1981

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). The leasing rules have generated a great deal of confusion and misunderstanding. I am happy for the opportunity to further explain these rules and to reemphasize their role in the President's program.

Background

The "safe harbor" leasing rules of the ERTA originated in and were developed by the Office of Tax Policy in the Treasury Department. They were included in the first bipartisan tax bill (H.R. 3849) introduced on June 9, 1981. The tax package considered by the Senate Finance Committee in June, which resulted in H.J. Res. 266, also contained the leasing provisions, as did H.R. 4260, the July 24 bipartisan substitute bill in the House. Thus, these provisions were clearly and conspicuously a part of the bipartisan tax package for capital formation from its inception to its passage in August.

The leasing rules are an integral part of the President's tax program to restore economic growth. All reports up to now indicate that they are working as intended to spur investment. Every lease is associated with spending for new equipment. Much of this spending would not occur otherwise.

"Safe harbor" leases allow all companies making new investments full access to the incentives in the recent tax bill. Without these rules, unequal competition for funds would have arisen, additional financial barriers would have been presented to new companies, and additional pressures for mergers and takeovers would have been created. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

R-528

The Investment Incentives of ERTA

To see the need for the new leasing rules, the operation of the investment incentives in the recent tax bill must first be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. This is a valuable incentive, for when firms must postpone deducting the cost of new assets, the value of those deductions is lowered. A dollar that a corporation can deduct today is usually worth $0.46, because the tax rate is 46 percent. If the company must delay taking the $1.00 deduction for five years, however, its present value is reduced to only $0.26 for a company earning 15 percent on investments. Conversely, accelerating the deductions for expenditures on new equipment increases the value of those deductions to the firm. Accelerating deductions effectively lowers the cost of buying the equipment and raises the after-tax rate of return on that investment.

The increase in after-tax return on equipment that comes from accelerating cost-recovery deductions is the major direct investment incentive in the President's tax program. But these early deductions may occur at a time when the new machine is producing little income. Thus, the deductions will serve their purpose only if they can offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to firms that can use them, then the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans and, thus, large deductions for cost recovery; and firms with temporary domestic losses, but profitable investment opportunities. More rapid deductions for cost recovery will moderately increase the number of such currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

An Example

To see how one type of company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco Manufacturing Company (Newco), making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed under ACRS to take deductions of $37,000 and an investment credit of $10,000. To use all of these tax benefits Newco will need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from older assets, Newco would have to postpone using some or all of the ACRS benefit, and the new tax bill would have increased Newco's after-tax return on new investment by less than that of other companies. Newco's return from that investment would be lower than that of corporations that can use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms, such as Newco, to invest in new equipment even though their investments have not yet produced large profits. Newco may allow some other firm, Taxable Corporation, which does have significant taxable income, to purchase Newco's $100,000 of new equipment for tax purposes and to lease that equipment back to Newco. This allows Newco to use the equipment in its business, but at the same time permits Taxable Corporation to take the resulting investment credit and accelerated deductions against its other income.

In this typical example, the user of the equipment (Newco, the lessee) provides financing for all but Taxable Corporation's downpayment. The terms of the agreement can be arranged so that rental payments owed by Newco to Taxable Corporation just match the reverse payments for debt service. In addition, the agreement may allow Newco to repurchase the asset at the end of the lease term for a token amount. In such a case, only the downpayment actually changes hands between the two companies. This payment is the agreed value of the tax benefits transferred by the lease.

All of the essential elements of a safe harbor lease transaction are shown in the accompanying three charts. The first chart shows the tax benefits of ACRS and the investment tax credit due to a purchase of a new machine for $100,000. These are all the investment incentives that are available from any purchase of 5-year ACRS property. No extra benefits are created by the lease.

In the second chart, we show the tax implications of a 10-year lease for a typical lessee, such as Newco. The lessee has given up the right to the investment credit and the ACRS deductions, but now has tax deductions each year for rental payments in excess of taxable interest income. Newco has, in effect, retained a share of the tax benefits associated with equipment purchases, but has stretched them out over the term of the lease. If, for example, the lessor makes a downpayment of $29,000 for the property, the lessee will have a total of $71,000 of deductions, providing tax reductions in the pattern shown in Chart II. Thus, the lease arrangement postpones the lessee's deductions until the later years when the investment will generate enough income to use the deductions.

Turning to the lessor, Chart III shows that the lessor obtains the investment tax credit and some net extra tax deductions in the early years of the lease, but also has extra net taxes due in the later years of the lease. The tax savings in the early years result from cost recovery deductions and the investment credit just as in Chart I, but these are partially offset by a series of extra tax payments through the remaining term of the lease. These extra payments occur, despite the fact that no cash changes hands, because for tax purposes the lessor is credited with taxable rental income and charged with deductible interest payments. These net tax payments of the lessor are exactly equal, every year, to the tax benefits of the lessee.

The Outcome of Leasing

There are three important aspects of such a lease which are illustrated in the charts. First, no extra deductions or tax credits are ever created. The total deductions taken by both parties are just the same as would have been taken if Newco had taxable income from other investments or if Taxable Corporation made the investment directly. They are exactly equal to the legally prescribed ACRS deductions and investment tax credit. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative, but much less desirable way to accomplish the same result, would be by actual merger of the two companies.

The second critical point is that virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, i.e., Newco. This is because Taxable Corporation, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for such deductions is becoming very competitive. The present value of the stream of tax benefits and future liabilities of the lessor, as depicted in Chart III, is about $29,000 when discounted at 15 percent. Put another way, Taxable Corporation can afford to pay up to $29,000 for this stream if the investment credit and all the deductions are expected to be usable when available, and if the interest cost of funds is no more than 15 percent.

The present value of the total of the available investment credit and ACRS deductions (Chart I) is about $45,000, not the $29,000 paid by the lessor. But this does not mean that Newco loses the difference between the $45,000 of foregone benefits and the $29,000 cash payment from Taxable Corporation. As noted before, Newco still has available deductions over 10 years equal to the amount of its $71,000 net cost of acquiring the property.

So long as the investment returns a sufficient profit to use these later deductions, the tax savings from them are worth $16,000 in present value terms. Thus, Newco will receive virtually the full $45,000 value of ACRS--$29,000 from Taxable Corporation and $16,000 worth of tax savings of its own.

This is a crucial result, for it means that the investment incentive inherent in ACRS has remained just where it should be--in the hands of the firm that will undertake the new investment and employ the new equipment. Although Taxable Corporation takes the credits and ACRS deductions on its tax returns, Taxable Corporation pays for those credits and accelerated deductions and pays additional taxes. Newco ultimately receives all the benefits of ACRS except transaction fees.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not encourage uneconomical or tax-motivated investment. Even with the lease agreement, Newco makes a substantial investment in the asset, $71,000 in our example, and the income that asset generates will be taxed. Unless the asset produces enough income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as provided to firms with taxable income. With those incentives equally available, firms can select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Misconceptions About Leasing

I have dwelt at some length on the details of the lease transaction because misunderstanding of these transactions is apparently the basis of much recent criticism of the safe harbor provisions. It has been said, for example, that these leases are a "bonanza" for those profitable companies able to purchase deductions and credits as "tax shelters." The opposite is proving to be the case. We have already begun to see the new rules resulting in more of the benefits passing through to users of the new equipment.

Tax-oriented leasing has been a significant feature of the economy for many years. Prior law, however, restricted and unduly complicated lease arrangements. Consequently, lease transactions required complicated agreements and legal uncertainties resulting in high transaction costs, including large legal and brokerage fees. These high costs reduced the net tax benefit (investment incentive) available to companies making an investment. The new simpler and more precise rules are resulting in lower costs and thus substantially more of the tax benefit will remain with those making the investment and less will go to compensate brokers, lessors and lawyers for taking leasing risks or attempting to avoid them.

Others have said that the new leasing rules are just another way to "bail out" loss companies. However, the fact that tax leasing will aid companies with economic losses does not detract from the desirability of the new leasing rules. These companies cannot use leases unless they undertake new investment in machinery and equipment. They will not make new investments if they do not expect them to be profitable, with or without leasing. Further, with or without leasing, the marketplace will not provide these firms with the capital to make these investments unless the marketplace also believes the investments will be profitable. There is no sound reason to penalize these firms, once they have withstood the critical analysis of lenders and investors in the free market, by forcing them to incur a higher cost of capital than their competitors. Indeed, such a penalty is singularly counterproductive. For most loss firms to become profitable, they must be able to modernize their plant and equipment. Penalizing them when they do invest only serves to make it more difficult for them to become profitable.

If tax leasing were not allowed, inefficient investment decisions would result. Otherwise-identical firms would face different capital costs depending solely on whether they had income from older assets. For example, Newco, which cannot take advantage of ACRS, might not make a particular investment even though, with the same tax incentives as other firms, that investment would be profitable to Newco and valuable to society. Alternatively, Taxable Corporation, the firm with income from older assets, might undertake the same investment rather than Newco, because of greater tax incentives. This could occur even though Taxable Corporation might lack some of the expertise to pursue the investment as efficiently as Newco. Finally, Taxable Corporation might acquire Newco so as to take advantage of Newco's unused ACRS deductions. Such tax-motivated mergers would serve no economic purpose, but would lead to a greater concentration of economic power.

Some critics have agreed with the importance of investment incentives for distressed companies, but express dismay that profitable companies are also cashing in their unusable tax benefits through leasing. Leasing by profitable companies with no current tax liability is neither surprising nor undesirable. It isn't even new. Many companies with tax losses have routinely used tax leases to make use of depreciation allowances and the investment tax credit. However, such transactions were effectively limited to equipment with a ready resale market, such as airplanes, railroad cars, and oil rigs. The new rules will end this discrimination, making leasing available for all kinds of machinery and equipment, and in the process will provide a larger share of the benefits to the equipment-using company.

A company may be currently nontaxable and yet economically profitable for a number of reasons. Our hypothetical startup company, Newco, is one example. With ACRS, rapid investment growth can result in continuing tax losses for such companies as deductions outpace current incomes. In another case, a company might have worldwide profits subject to tax abroad, but also have losses from U.S. operations resulting in excess foreign tax credits. Leasing provides the incentives of ACRS to such companies for investment in the United States. Leasing may also be of benefit to companies with capital gains income, excess depletion allowances, and perhaps other conditions that limit the current use of deductions. In every case, the same two basic principles continue to hold: (1) every lease is associated with new investment expected to be profitable and (2) no more tax benefits are available to these companies than would be provided to their currently-taxable competitors.

In any year, a disproportionate number of companies with tax losses are small businesses. While such companies may not yet have made use of the leasing provisions because information reaches them more slowly and legal fees are initially large, there is every reason to believe that a ready market for small leases will become available through local financial institutions. Again, without leasing, the potential for job-creating investment by such businesses would be reduced and the market pressure for merger or takeover by mature taxable companies would be increased.

Revenue Effects

One last point to address is the revenue cost of leasing. Before I discuss some unfounded criticisms of our revenue estimates, I want to clarify the interpretation that should be placed on the revenue cost figures. New investment in equipment must be made for leasing to take place. In calendar year 1983, additional leasing attributable to the safe harbor rules is associated with $17.3 billion of investment (see attached Table 1). We can not say for certain how much of this investment would have occurred without liberalizing the leasing rules, but we know that the leases are necessary to provide the full benefits of ACRS, the basic investment incentive in the new law. Therefore, we are convinced that the leasing rules will significantly increase the level of investment. The revenue losses from leasing are one measure of its success--direct costs to the Treasury are associated with the higher levels of investment that our economy needs.

Turning to the accuracy of our estimates, there has been a general misunderstanding which has led to press reports that Treasury underestimated the revenue impact of this provision. In fact, our original cost estimate is consistent with the high volume of leasing we are observing. We expected that the provision would be widely used and, so far, our forecast appears to be on target. The first-year revenue loss estimate is based on an estimated total of $17.8 billion of safe harbor leases in 1981. This is well within the range of press reports.

As shown in the attached table, our estimate of foregone receipts remains $29.1 billion over the six-year period, 1981-1986. This estimate is associated with $126 billion of equipment that would not have been leased in absence of the safe harbor rules. These induced leases are, however, less than half of the total dollar volume of safe harbor leases which we estimate will occur. The remainder of the observed safe harbor leasing activity consists of leasing that would have occurred anyway, under prior law or under the general provisions of ACRS. Some of those leases induced by the general provisions of ACRS would have taken the form of actual mergers rather than leasing arrangements in absence of the safe harbor rules.

To the extent that leasing activity is attributable to prior law or to the general provisions of ACRS, there is no further revenue loss to the Treasury. Revenue costs associated with this activity have already been properly included in the general level of corporate receipts. (See Table 2.)

Conclusion

Mr. Chairman, let me conclude by pointing out that this is a particularly inopportune time to talk about reducing any incentives to invest in new machinery and equipment. This investment is important for job creation in the near-term, and for productivity and economic growth in the years ahead. The safe-harbor lease provision is a market-oriented means of providing equal and effective investment incentives to all businesses.

The Administration does not favor any legislative changes in this provision. It is an efficient incentive, and according to every report, it is working very well. The new leasing rules deserve the continued support of the members of this Committee.

Attachments

Chart I

Investment Credit and ACRS Deductions

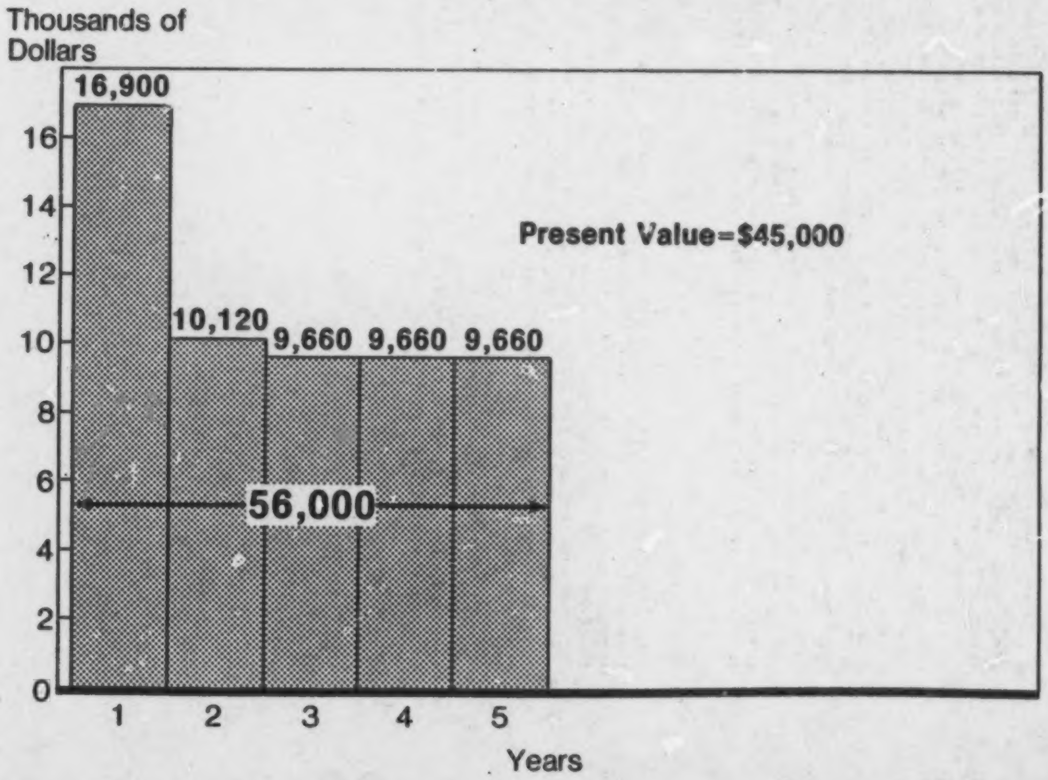

Chart II

Lessee (New Co.)

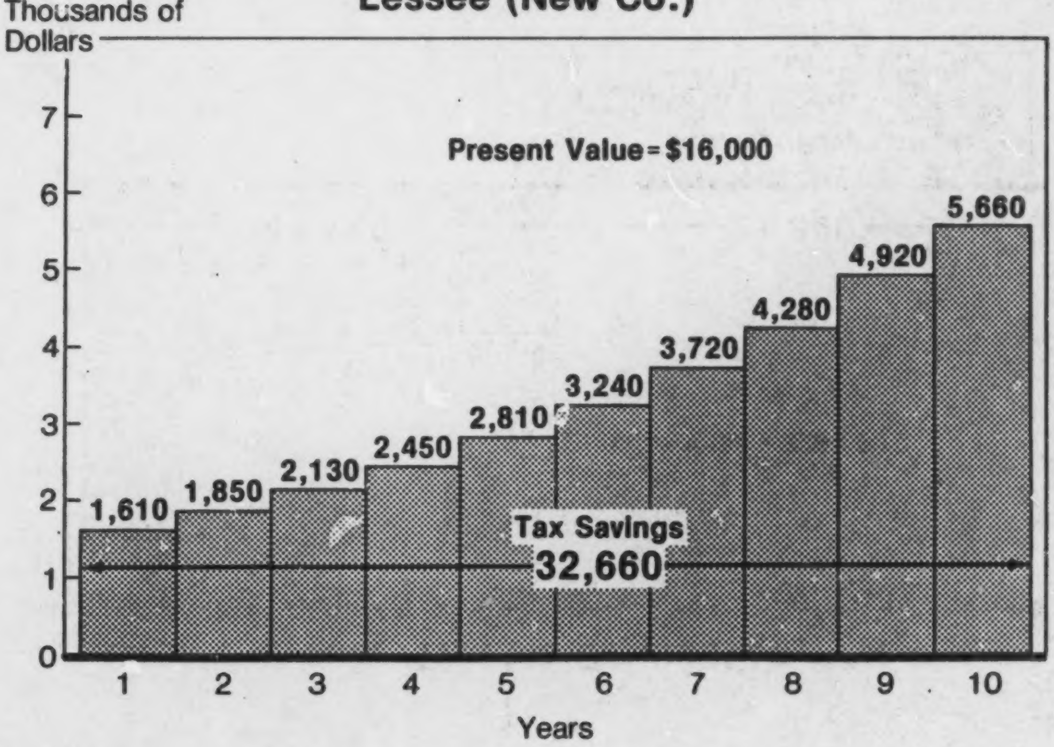

Chart III

Lessor (Taxable Corporation)

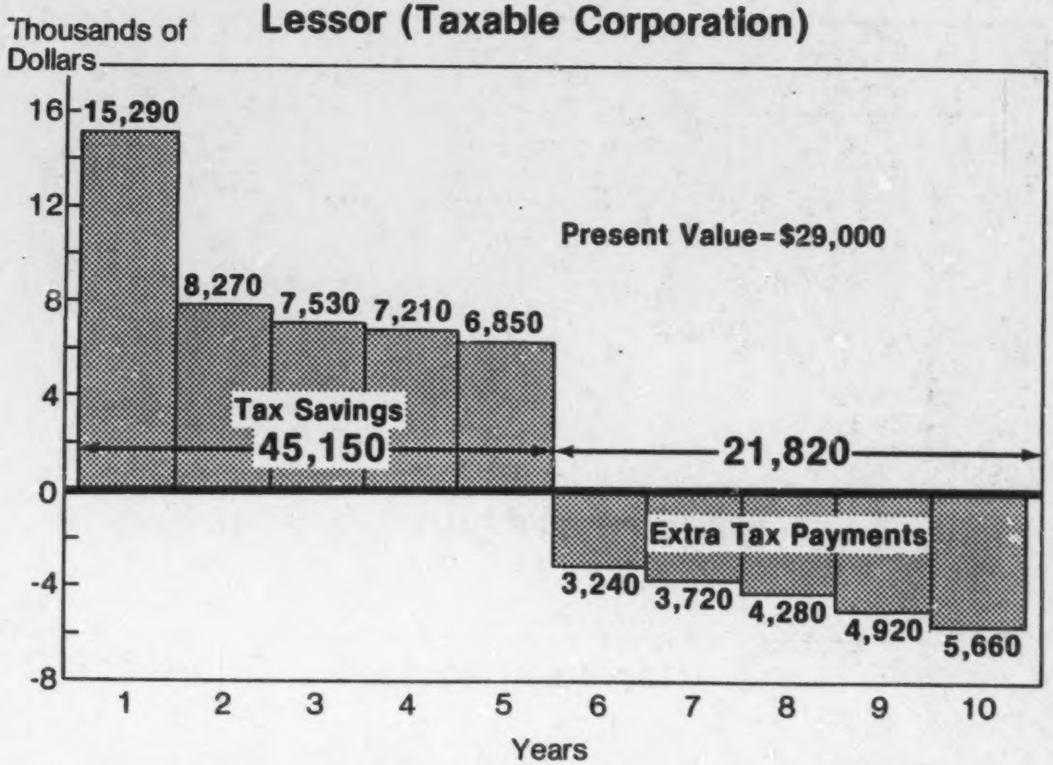

Table 1

Estimates of Safe Harbor Leasing and the Loss in Receipts Attributed to the Safe Harbor Leasing Rules

($ billions)

	Years					
	1981	1982	1983	1984	1985	1986
Total value of equipment leased under the safe harbor rule.........	17.8	29.0	39.2	46.8	59.6	70.9
Less the value of equipment leased under the safe harbor rule which would have been leased under prior law..........................	5.0	11.0	12.1	13.3	14.6	16.1
Less the value of equipment leased under the safe harbor rule which would have been leased under the general provisions of ACRS 1/......	2.0	4.3	9.8	11.7	17.4	20.0
Equals the value of equipment leased under the safe harbor rule which would not have been leased under prior law or under the general provisions of ACRS.................	10.8	13.7	17.3	21.8	27.6	34.8
Loss in fiscal year receipts from incremental leasing added by the safe harbor rule....	0.5	2.7	3.8	5.4	7.3	9.4

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1981

1/ Included in these figures are investments made by nontaxable corporations which would have been merged into taxable corporations in absence of the safe harbor rule.

Table 2

Corporate Income Tax Receipts under Midsession Review Budget Economic Assumptions
With and Without the Effects of the Accelerated Cost Recovery System
and Leasing Provisions of the Economic Recovery Tax Act of 1981

($ billions)

	Fiscal Years						
	1980	1981	1982	1983	1984	1985	1986
Corporate income tax receipts under 1980 law	64.6	64.9	72.6	84.4	97.2	109.1	122.9
Economic Recovery Tax Act of 1981:							
Accelerated cost recovery system	--	-1.3	-4.6	-10.2	-17.8	-27.2	-42.2
Leasing	--	-0.5	-2.7	-3.8	-5.4	-7.3	-9.4
Other	--	*	-0.3	0.5	-0.6	-2.3	-2.6
Total	--	-1.8	-7.6	-13.5	-23.9	-36.8	-54.2
Corporate income tax receipts under current law	64.6	63.0	65.0	71.0	73.3	72.3	68.7

Office of the Secretary of the Treasury
Office of Tax Analysis

December 9, 1981

*Less than $50 million.

Note: Details may not add to totals due to rounding.

Mr. CHAPOTON. I do not want to repeat everything I said in the earlier testimony, but I do want to reemphasize certain fundamental points about leasing in general and as it may apply to small business in particular.

At the outset let me state that we are strongly behind the leasing provisions. We stand firm in our conviction that they are a necessary part of the President's program. We do recognize the problems that have been raised about leasing.

Therefore, we welcome the opportunity to appear before this committee today to explain the rules and to answer any questions you might have.

The leasing rules are an integral part of the President's cost recovery program that was adopted by the Congress last year. It should be kept in mind that every lease is associated with spending for new equipment, and much of this spending would not have occurred without the leasing provisions.

The leasing rules to not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

To see the need for leasing, the operation of the investment incentives of the Economic Recovery Tax Act, ERTA, should be clearly understood. The principle investment incentive in that act is the acceleration of cost recovery deductions. The acceleration of deductions effectively lowers the cost of buying new equipment and thereby raises the after-tax rate of return on investment.

This increase in the after-tax return is the primary investment incentive in the President's tax program, but a problem arises if the accelerated cost recovery deductions become available when the new equipment is producing little income. In that case, the deductions will serve their purpose only if they can be used to offset other taxable income.

If a company does not have other taxable income or cannot transfer its deductions to a firm that is able to use them, the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

Let me give you an illustration of how this works in practice. If you consider a new firm, which we call Newco, that makes $100,000 investment in new equipment, in the first 2 years the company has that equipment after the equipment is placed in service, and the ACRS deductions on a $100,000 piece of equipment totals $37,000. The investment tax credit is another $10,000.

To fully utilize these benefits, that firm will have to have net income before ACRS of approximately $59,000. We know that most investments even in the most highly profitable industries do not yield income in the first 2 years of over 50 percent of the cost of the asset.

Therefore, without income from other assets, our company in this example, Newco, would have to postpone using some or all of the ACRS benefit, which in turn would make Newco's after tax return on the new investment less than that of its competitors.

The essence of the new leasing rules is that ACRS will provide incentives for firms like Newco to invest in new equipment even though their investments have not yet produced large profits. This allows Newco to use the equipment in its business, and at the same time to permit it to enjoy the benefits of the investment credit and accelerated deductions.

There are three important aspects of leasing that should be kept in mind. First, leasing creates no extra deductions or credits. The total deductions and credits available under leasing are equal to at most those that would be available if the investor and the user of the equipment had taxable income and could fully utilize the deductions and credits in its own business. Therefore the Treasury loses no more revenue than if that were the case.

It might also be noted though that an alternative but much less desirable way to accomplish the same result, that is full utilization of these tax benefits, would be by an actual merger of Newco with a mature company wishing to reduce its own tax liability.

The second point I want to make about leasing is that virtually all the tax benefits of ACRS will be passed through to the company actually making the new investment, Newco in our example, and a little of the tax benefit will stay in the leasor. It is already apparent that a market for tax benefits is and is becoming more competitive. From our preliminary analysis of a small sample of sale and lease back transactions closed in 1981, we found that a very high percentage of the tax benefits from leased property are being passed through to the lessees. This passthrough of benefits should increase as safe harbor leasing becomes more routine as a market transaction and therefore more efficient.

The third essential point about lease transactions is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable.

In spite of what you may sometimes read, leasing does not foster uneconomical or tax motivated investments. Even with the leasing rules, Newco in our example makes a substantial investment in the asset, and the income that asset generates will be taxed. Unless the asset produces sufficient income, Newco will not be able to make a profit on its investment and therefore will not make the investment.

The tax incentives are equally available to all firms under the leasing rules. Thus firms are made able to select investments on the basis of their economic profitability and not on the basis of tax circumstances.

We are of course aware, Mr. Chairman, of the various bills which have been introduced to repeal or cut back on the leasing provisions. We are mindful of the size of the deficits projected and the shortrun effect a repeal would have to alleviate the deficits.

As the chairman stated in his opening statement, while that might have a shortrun effect, we think in the longer term the repeal of leasing would do much to undercut the investment incentives adopted by Congress last year, and the longrun effect would be a decline in investment and a concommitant reduction in economic activity.

I should also add that we think if leasing is repealed much of the impact would fall on small business.

As I mentioned, leasing is intended to help those firms which cannot fully utilize the tax benefits associated with new investment. A typical firm in this category would include a new firm or a firm which does not have sufficient income from other assets to absorb the tax benefits. Firms in these categories are often smaller businesses.

Thus in relative terms, the retention and utilization of safe harbor leasing is at least as important to small companies as it is to larger ones. In spite of what we have heard about leasing not being utilized by smaller businesses, the information we have gleaned from the lease information returns received thus far indicates that many smaller companies have been able to use the leasing rules effectively, even without the aid or assistance of large professional brokers or investment bankers.

We have received nearly 16,500 lease information returns through the beginning of last week. They represent an estimated 14,500 lease transactions. Some of the transactions involve multiple leases.

Of these transactions, fewer than 500 represent agreements involving property worth more than $1 million. The remaining 14,000 transactions or over 95 percent of the total cover property worth less than $1 million. Most of these smaller transactions cover property worth less than $100,000, and many of these smaller ones involve straight or leveraged leases, that is leases in which the lessee does not sell the property to the lessor and lease it back, not a sale-lease back transaction in these smaller cases where the tax benefits only are transferred, but often what I will refer to as straight leases where the financing is done by the lessor or a party on behalf of the lessor.

We have not yet been able to analyze the data on the straight lease transactions, but we fully anticipate that the same positive benefits flow to the user of equipment in those types of transactions that we are finding under a sale and leasejack arrangement.

Many small companies lease their typewriters or copying machines, office furniture, and the like. Before safe harbor leasing the savings realized by these companies through leasing versus buying the equipment depended in large part on the uncertain value of the property at the end of the lease term.

By eliminating the need to take the value of the residual into account, the safe harbor rules have made straight leasing more efficient. As a result, more of the benefit of leasing should pass through to the user of the equipment. We should note that many of these leases would have taken place in the absence of the safe harbor rules but would have been less beneficial to the lessees.

As I noted, we completed a preliminary analysis of a small number of sale and leaseback transactions. Our analysis indicates that about 88 percent of the tax benefits of leased property is being passed through to or retained by the user of the equipment. Although this sample is too small to generalize and it does not apply to the straight lease transactions and we have not had an opportunity to analyze those, this analysis does indicate that the percentage of benefits passed through are about the same regardless of the size of the lease and that they appear to pass through fairly uniformly over industries.

We are currently analyzing the remaining lease information and should be able to provide this committee with additional data on the effect of leasing on small business within the next few weeks.

Let me turn to leasing and the at-risk rules to which the chairman referred in his opening statement. The application of the at-risk rules to leasing has drawn a lot of criticism and concern from the small business community.

Code section 465 limits the amount of losses that certain closely held businesses may deduct with respect to an activity to the extent of the amount they have at-risk in the activity. This at-risk concept was introduced in the Tax Reform Act of 1976. It is basically a measure to restrict tax shelters by altering the timing of deductions so that a taxpayer may not claim deductions in excess of the amount of cash and recourse debt that he has invested in the activity as of the end of the taxable year.

Individuals, subchapter S corporations, and closely held businesses—those in which there are five or fewer individuals who own more than 50 percent—are subject to the at-risk rules. The rules were extended in last year's act to apply to the investment tax credit as well.

Except in the case of a subchapter S corporation or a personal holding company, the new leasing rules do not expressly prevent closely held companies from engaging in leasing transactions. However, the regulations do make it clear in interpreting the law that the at-risk rules apply in determining the amount of deductions and credits a purchaser of a tax benefit, that is the lessor, may claim.

When we were analyzing these rules before regulations came out last fall, I indicated in a speech I made in New York that the at-risk rules may not apply to closely held lessors in safe harbor leasing transactions. However, as we worked with the Internal Revenue Service and in our own office in developing regulations, we concluded that the leasing regulations could not add an exception to the at-risk provision of 465 without express statutory authority. There simply was no amendment to 465 in last year's act and we did not feel we could add one by regulation.

The small business community has suggested that the leasing provisions should be amended to relax the at-risk restrictions as they apply to safe harbor leasing rules. We have considered the desirability of a statutory change to relax the at-risk rules as they apply to the lessor. Our initial reaction is that there may not be a need for such a provision.

I want to point out that the real beneficiaries of the new leasing rules are and should be the lessees, that is the user of the equipment that is selling the tax benefits, and not the lessor.

Closely held companies are not disadvantaged because they clearly can be lessees. Anyone can be a lessee, including an individual.

The rules are not designed to benefit the lessor in the transaction. They are designed to benefit the lessee. Any profit earned by the lessor on a leasing transaction is a payment to the lessor for advancing the money to the lessee for the ACRS deductions and credits which the lessee is otherwise entitled to.

The effective exclusion of closely held companies as lessors discriminates in favor of large companies only to the extent that large companies have an additional investment option available to them. It does not mean that closely held companies are denied the benefits of leasing.

It has been suggested that an amendment to ease the at-risk rules is needed because small companies will deal only with other small companies. We have not seen any specific evidence of that. We would, I think, question the statement that there is a natural hesitancy on the part of small companies to deal with large companies in leasing transactions.

However, on the other hand, we would agree that since the leasing provisions are market oriented there is no reason to curtail the universe of potential lessors by discriminating among corporations that are allowed to be lessors.

Also, we are satisfied that there are sufficient safeguards within the leasing rules that a change in the at-risk rules of section 465 would not open any abuse that the at-risk rules were intended to prevent.

Thus, although we have some doubts that any amendment to relax the at-risk rules as they apply to lessors would have any appreciable effect on the benefits of leasing flowing to small business, we would not oppose a carefully developed legislative change along this line.

In summary, let me just state, Mr. Chairman, that it is not surprising that the large transactions are the ones that make the newspapers and are the ones that we all read about, but there are a large number of very small transactions using the safe harbor leasing provisions. These smaller transactions are very important to the small business community and to the economy as a whole.

Small businesses are already using the provisions. We think they will continue to use them in greater numbers and with greater efficiency as the leasing rules become more standardized.

I might add that we do not think this is an appropriate time to be considering cutting back on the leasing rules or limiting the worthy use of this incentive device in the tax law.

Thank you, Mr. Chairman. I will be happy to answer any questions you or Senator Nunn might have.

Senator D'AMATO. I note that Senator Nunn is now here.

Senator, do you have an opening statement you would like to make?

Senator NUNN. I will deliver it with my maximum efficiency by simply inserting it in the record with your permission, Mr. Chairman.

Senator D'AMATO. So ordered.

[The prepared statement of Senâtor Nunn follow:]

STATEMENT OF SENATOR NUNN

We are here today to examine the merits and weaknesses of the safe harbor leasing rules which allow businesses to sell unused tax credits to other firms.

The safe harbor leasing rules included in the Economic Recovery Tax Act of 1981 have been the subject of considerable comment and controversy. In the first place, the Administration introduced the leasing provisions during the late stages of the debate over last summer's tax cut package. As a result, Congressional hearings were never held on the subject, and the concept of leasing unused tax credits was therefore never scrutinized. There is concern among many of us, for example, that the leasing provisions effectively subsidize inefficient firms precisely when we are attempting to raise the competitiveness of American industry. Moreover, the provisions are expected to produce a revenue loss to the U.S. Treasury of $30 billion over six years at a time when we face escalating federal budget deficits.

Of particular concern to me, is the way the Treasury's leasing regulations discriminate against small business by denying closely-held corporations the right to purchase another company's investment tax credits and depreciation deductions. The leasing statute itself appears to expressly permit purchasing of tax benefits by closely-held corporations (other than Subchapter S corporations and personal holding companies). The Treasury Department, however, has applied the so-called "at risk" rules of the Internal Revenue Code to purchasers of tax benefits, and the application of these rules effectively prevents small closely-held companies from purchasing tax benefits in sale-lease back transactions which are otherwise allowed under the new leasing statute. Discrimination results because the "at risk" rules impose no restrictions at all on widely-held companies.

The regulations on this point were a reversal of a position expressed by Mr. John Chapoton, Assistant Secretary of the Treasury for Tax Policy, in a speech to the Tax Society of New York University on October 5, 1981, shortly before issuance of the regulations in question. In that speech, Mr. Chapoton stated that the regulations would apply the "at risk rules" only to the lessee or user of the equipment, and not the lessor. Mr. Chapoton went on to say that this would be consistent with the underlying purpose of the leasing statute. However, Treasury later concluded that the language of the "at risk" statute required the application of the "at risk" rules to lessors, and that Treasury could not change this result without express statutory authority.

I am unconvinced that the leasing concept is the most efficient way of compensating unprofitable firms for unused tax credits, as I am equally unconvinced that businesses should be compensated at all for their inability to use available tax credits. However, if we are to have leasing, it makes no sense to restrict the universe of eligible lessors to the larger businesses of the country. When big corporations seek to buy tax benefits, they naturally look for big-dollar transactions. They are not interested in the small business which wants to sell tax benefits in order to help finance a modest capital expansion program. It is, rather, the successful small businesses in a community which will be interested in buying tax benefits on a relatively small scale.

Obviously then, if the leasing provisions are to remain in place, we should explore the merits of removing the anomalous and discriminatory effects which result from applying the "at risk rules" at the lessor level.

Senator D'AMATO. As you know, there has been great contention over the future of safe harbor leasing. This morning there was an editorial in the New York Times called "The Unpopular Case for Tax Leasing." It basically comes out in very strong support.

The question of tax leasing is one that I think many in the press and the public have an incorrect perception of as giving additional financial opportunities to the wealthy corporate sector of America, the very sound sector, and financing this with a raid on the taxpayers of this Nation and on the Treasury.

Total revenue loss from safe harbor leasing is estimated to be somewhere in excess of $33 billion by the end of fiscal 1986. This of course does not account for any of the feedback into the economy.

How much do you estimate will be flowing back into the Treasury, if anything, as a result of leasing by 1986 as a result of increased capital formation, et cetera, that otherwise would not have occurred?

Mr. CHAPOTON. Mr. Chairman, we are asked that type of question with regularity. It is difficult for us to quantify the flowback of any particular provision in the tax law.

We know that the leasing rules do encourage investment. We know that with the existence of the leasing rule much investment will be made that would not be made in absence of the leasing rules. We really do not have the capability though to trace through and see the overall revenue effect of that.

We know that with investment and greater productivity in this country the entire pie grows and we are all better off as a result, but it is simply not possible for us to quantify any specific provision in the tax law which will have that impact as far as revenues are concerned.

Senator D'AMATO. In essence, what you are saying is it is your belief that this estimate of a loss of $33 billion plus through 1986 is worth the economic growth and expansion that would otherwise not take place?

Mr. CHAPOTON. That is correct. It is needed for the economic growth, for the impetus that it gives in the growth in our economy. It is a benefit associated with investment in every case. We need the investment.

Senator D'AMATO. In your testimony you indicated that 88 percent of the benefits are passed through to the actual users, the lessees, and, in addition, that 95 percent of those leases you have been able to analyze are for equipment of less than $1 million. Indeed, in most cases, it would fall under $100,000.

Mr. CHAPOTON. That is correct.

Senator D'AMATO. Have you been able to do any analysis with respect to what the proportion of these leases are that involve the small business entrepreneur, those companies that employ fewer than 500 employees?

Mr. CHAPOTON. No, Mr. Chairman. This data is just coming in. We have not been able to do that. I think it is safe to assume that a large portion of the smaller transactions will involve smaller companies, but until we match the data with the taxpayer identification number we cannot see the actual size of the companies involved.

Senator D'Amato. How long before you think you will be able to get to that?

Mr. Chapoton. I think by the end of this month. I do not want to over promise, but by the end of the month we will have a much better analysis of the 1981 transactions.

Senator D'Amato. I think that information is of critical importance if we are to determine whether or not leasing is an effective tool of capital formation for small business.

In my opinion, this data will offset to a great extent those stories where we see the large conglomerates taking advantage of the tax benefits of leasing. I think it is important to see that small companies who otherwise would be precluded from activity and investment are using safe harbor leasing. I look forward to getting this information as quickly as possible.

Mr. Chapoton. Yes, sir.

Senator D'Amato. I have one other question that gets to the whole issue of whether or not closely held corporations are discriminated against. I appreciate your candor.

I just suggest two things. While you say that it is the intention, and indeed 88 percent of the benefits that are derived go to the lessees, obviously there is a benefit to the lessors. Otherwise they would not participate.

Mr. Chapoton. Correct.

Senator D'Amato. It would seem to me that equity should bring about a situation whereby the closely held corporation, the small family held business, should also have the opportunity to be either a lessor or a lessee.

However, you said very clearly that in your opinion the lessee activity, even if it is a closely held corporation, does qualify for favorable tax treatment. Is that correct?

Mr. Chapoton. Unquestionably. Lessees qualify without regard to how closely held the business.

Senator D'Amato. The user then qualifies.

Mr. Chapoton. Correct.

Senator D'Amato. All right. It is just a question of the lessor.

Mr. Chapoton. Correct.

Senator D'Amato. To that extent we have a discriminatory situation. You would not oppose then a legislative formula dealing with this or a legislative solution to bring about equity in this area?

Mr. Chapoton. That is correct. We would not oppose legislation. We look at the history of the at-risk rules which are probably desirable rules and we think they probably are not needed in this area. Therefore we would not oppose a change.

We want to be careful that the change is carefully drafted, but I think it can be to meet any concerns we would have.

Senator D'Amato. Senator Nunn?

Senator Nunn. Thank you very much, Mr. Chairman.

I am delighted; we are having these hearings to try to clarify what is becoming an increasingly controversial element of last year's tax bill.

Mr. Chapoton, we are delighted to have you here this morning. I know you know more about this than anyone in the executive branch. As I see it, we are hearing from the expert.

I am trying to catch up on all that has been testified to so far without going back over it, but as I understand it you said that the revenue loss associated with leasing provisions are estimated at $30 billion over the 6 years. Is that about right?

Mr. CHAPOTON. Yes, sir, that is about right. It is a little over $30 billion to 1986.

Senator NUNN. How confident are you of this revenue loss estimate? Is this a high confidence loss estimate?

Mr. CHAPOTON. I suppose in view of the controversy this area has engendered over the last several months we have reviewed that estimate as closely as any estimate we have reviewed. It turns on how much utilization there will be of this new provision.

A factor that most people do not fully appreciate is that there was high utilization under prior law of leasing as a means of passing tax benefits from an investor who could not use the benefits of new equipment to another party who could. That is leasing under the old law where the economic ownership had to be in the lessor which was highly utilized.

Under the safe harbor rules, leasing will grow. The question is to what extent we have induced leasing by the new safe harbor rules, therefore making tax benefits available that would have otherwise been lost. To the extent we have, we have reduced the revenue, but we have encouraged investment.

We think we have a good fix on what the induced leasing will be. Indeed, we project very high utilization, as those figures show. We are not concerned that it is getting out of hand as has been suggested in several accounts.

Senator NUNN. When you testify that you want to retain these provisions, I assume that the $30 billion revenue loss over 6 years is thought by you to be a very valuable stimulus to economic incentives for investment. Is that right?

Mr. CHAPOTON. That is right. We consider it just an integral part of the cost recovery system which itself is expensive in those static revenue loss terms.

Senator NUNN. What is that loss over the same 6-year period?

Mr. CHAPOTON. I do not have them totaled here, but to give you year by year, the 1982 total benefits—these are fiscal year—would be 7.6, of which leasing was 2.7; 1983, 13.5 billion, of which leasing was 3.8; 1984, 23.9, of which leasing was 5.4. Of course once we get out there we are getting into numbers more difficult to project, but to go on, in 1985, 36.8, of which leasing is 7.3.

Senator NUNN. Are those figures and all those computations based on the same economic assumptions with which you compute the budget and the deficit and revenue and income?

Mr. CHAPOTON. That is correct. A big one here is the assumption about business fixed investment. If that goes up, these figures go up. If it goes down, these go down.

Senator NUNN. In catching up with your statement, I understand you are saying this morning that Treasury will not oppose a carefully drafted legislative amendment repealing the application of the at-risk rules to the lessor. Is that right?

Mr. CHAPOTON. That is right.

Senator NUNN. Do you have such a proposal yourself?

Mr. **Chapoton**. We have not actually drafted one, but we certainly have in mind what we would not oppose.

Senator **Nunn**. Will this be not opposing it or will this be an official administration endorsement?

Mr. **Chapoton**. It would be an endorsement of such a proposal. In view of the controversy of the leasing provisions, we do not feel that we should now be coming forward to broaden the leasing rules, but we are certainly not going to oppose this change.

Senator **Nunn**. It is my understanding that you said that the leasing provisions in your opinion will spur investment among firms that are incurring operating losses. Is that right?

Mr. **Chapoton**. It will spur investment among any firm, startup firm, old firm with carry over, that does not have current taxable income.

Senator **Nunn**. Can you quantify the expected increase in investment associated with the leasing provisions that might not otherwise occur?

Mr. **Chapoton**. Senator, we simply cannot do that any more than we can quantify the increased investment that will occur as a result of any greater tax benefits from investment. Some investment that will receive the benefits would have taken place without the investment, but we know that the cost of the investment is reduced and reduced significantly.

Therefore, we know more investment is made, but it is very difficult to quantify it.

Senator **Nunn**. How do you get the revenue loss that is going to occur without knowing the investments that would be made?

Mr. **Chapoton**. We get the revenue loss from assuming induced use of leasing. A part of the investment probably would be made without the new leasing, as I have stated.

Senator **Nunn**. The difficulty is not computing the overall investment which you do with higher confidence but in discerning how much of that would have occurred without the leasing provisions.

Mr. **Chapoton**. That is correct.

I want to put a footnote. When you say with high confidence, we make projections on investment and we think in this case that certainly we have not understated that, but when you get in the out years, the confidence factor is a little bit shakier on any projections of what the economy is going to be doing 5 years from now.

Senator **Nunn**. Can we count on the cooperation of the Treasury Department and staff in drafting legislation on this that would meet your approval?

Mr. **Chapoton**. Absolutely.

Senator **Nunn**. If you cannot quantify how much of this investment would not occur or would occur if these leasing provisions were repealed, can you quantify the effect on interest rates if you were to simply repeal the leasing provisions and therefore have $30 billion more in revenue to reduce the deficit?

Can you take $30 billion over 6 years and make an estimate of how much, if any, that would lower interest rates?

Mr. **Chapoton**. Senator, you immediately get into the question of indeed what effect deficits have on interest rates. There is a strong argument over that.

Senator NUNN. I understand the new position of the Treasury Department is it does not have much of an effect on interest rates.

Mr. CHAPOTON. I think it is always the question really of how the deficits are financed. I think most people agree on that. The deficits, as undesirable as they may be, do not directly have that effect.

I think it is also incorrect to look at the leasing rules as they are repealed and to decide you would automatically save that much money. You would do great damage to the accelerated cost recovery system. By that, you must affect investments businesses would make adversely You would have the same result if you repealed part of the ACRS.

We do know that business activity will be affected and affected in a negative way.

I want to emphasize that one of the primary factors of leasing is to make the investment incentive the same for all businesses. If you repealed the leasing rules, you would leave the investment incentives in place for investment for part of our business community and take it away for another major part of our business community.

Senator NUNN. Could you briefly go back over what you said about small businesses participating in this leasing provision? The chairman made reference to *x* number of transactions with $1 million or less, *x* number of transactions of $100,000 or less, and so on. Could you repeat that?

Mr. CHAPOTON. Yes, sir.

We have analyzed some 16,500 leasing forms that have come in. These represent about 14,000 transactions. Some of the transactions involve more than a single safe harbor lease. Of those, 95 percent are less than $1 million in transaction. A great majority of them are less than $100,000 per transaction, not per lease but per transaction.

Therefore, we think that a lot of the smaller businesses are utilizing leasing. They are making leases of property worth less than $100,000.

Senator NUNN. How do you reconcile that with what we hear. It may not be true, but what we hear is that it takes an awful lot of money just to pay a lawyer and a CPA to work up these leasing provisions. How can a transaction under $100,000 be economically feasible if you are paying these kinds of administrative and legal fees, or maybe you are not? Do you know what it takes to pay a lawyer to work these up?

Mr. CHAPOTON. We have that information on the forms. We have not been able to analyze it. We know that in the early transactions the costs were higher because of the uncertainty. We know that the transaction costs are decreasing.

However, you have to keep in mind that if I as a small businessman am going to make $100,000 investment in equipment and I cannot utilize any of the tax benefits, then I am leaving a lot of dollars on the table. Therefore it is going to be worth it for me to spend some money to take advantage of those tax benefits.

Hopefully, the transaction costs in obtaining those tax benefits will be as low as possible but, frankly, they can be fairly high and it will still be worth it for me to do it.

Senator NUNN. Do you have any analysis of how much it costs per transaction for legal and accounting fees or what the total cost for legal and accounting fees is going to be in order for this $30 billion revenue loss to occur?

Mr. CHAPOTON. No; we do not yet. However, in analyzing specific transactions just on an ad hoc basis, we were estimating between, I believe, 3 to 4 percent of the benefits involved. We know the transaction costs have decreased as the parties became more accustomed to the leasing rules and the forms became more standardized.

Senator NUNN. Will you try to get that information?

Mr. CHAPOTON. Yes. We will have that information. It is on the leasing forms. We will be analyzing that.

Senator NUNN. Will you supply that for the record?

Mr. CHAPOTON. Yes, sir.

Senator NUNN. Approximately how long will it take you before you get that? Will it take a couple of weeks to do it?

Mr. CHAPOTON. We are much in the midst of analyzing these rules. By the end of the month we will have more analysis on it. I cannot promise we will have the transaction costs as a percentage of the deal by the end of the month, but it should be shortly and in that range.

Senator NUNN. When you say that 95 percent of the transactions are under $1 million and a majority of those are under $100,000, you by implication say that is small business. Do you have information that indicates that those transactions under $1 million and under $100,000 are indeed the result of small businesses leasing?

Mr. CHAPOTON. No; we do not. I want to emphasize that. We have not yet matched up to see which businesses these are. Indeed some of them will be large businesses. It just stands to reason that when you get into smaller transactions, small businesses are doing it. That is just our conclusion from that information.

Senator NUNN. Does that preclude the possibility that a very large corporation may be filing a number of individual forms indicating individual leasing of equipment rather than compiling it all?

Mr. CHAPOTON. It does not preclude that. If a larger corporation is making a single transaction, say for a large purchase of equipment, we would have that data into one transaction and so it would not fall into that 95 percent. This 95 percent are individual transactions. There is nothing to prevent a large corporation from making a number of individual transactions, but historically we know that the much larger corporations are inclined in their financial arrangements to deal with larger transactions rather than smaller ones.

Senator NUNN. Will you be able to correlate the $1 million number and the $100,000 and under number to small businesses?

Mr. CHAPOTON. Once we identify the taxpayers involved, we will be able to correlate the size of the taxpayer.

Senator NUNN. Is there a definition we should expect in terms of defining what is a small business?

Mr. CHAPOTON. I think what we will probably do is put it in an asset category. We do not have a definition. There are a lot of definitions of small business and we do not have one that we use for this or for any other specific purpose.

Senator **Nunn**. I remember when the Kemp-Roth bill was being debated we heard over and over again in this committee and on the floor of the Senate and House and throughout the whole public debate that most of the small businesses in the country were unincorporated.

Mr. **Chapoton**. Yes.

Senator **Nunn**. Therefore the 10-10-10 was going to primarily benefit small business. Do you recall that argument?

Mr. **Chapoton**. Absolutely. That is certainly correct.

Senator **Nunn**. How do you reconcile that with the argument that this leasing provision is helping small business and yet by its very definition unincorporated small business is precluded?

Mr. **Chapoton**. Senator Nunn, that is a point we made earlier before you got in. The leasing rules from the standpoint of the lessee are not denied small business and are not denied individuals. If I am going to invest equipment and I want to lease my equipment, I can do so and obtain the tax benefits in that manner.

The portion of the leasing rules that is denied to closely held companies is the position of the lessor, that is the buyer of the tax benefits, not the user of the equipment.

Senator **Nunn**. Nevertheless, if you are going to help small business, they are precluded if they themselves want to buy and deduct this from their own tax loss, are they not?

Mr. **Chapoton**. That is correct. They are presently precluded as purchasers.

Senator **Nunn**. Even under your definition of at risk, if we make that change you are still going to be precluding most of the small business in the country from being lessors as they were defined during the Kemp-Roth debate, are you not?

Mr. **Chapoton**. That is correct. The purpose here was not to allow that. The position of the lessor is he pays for tax benefits. He is a conduit for getting the tax benefits to the user of the equipment.

If you allow individuals to be lessors, then you get into the problem of the graduated rates which I think would cause a lot of problems that I think we ought to try to avoid.

Senator **Nunn**. I can understand the problems. However, the so-called Kemp-Roth bill was promoted on the grounds that that bill would provide relief to small business since most small businesses are unincorporated.

Now we have another provision that, as I understand your argument this morning, is helping small business, and yet the very definition of small business that you used in that argument is totally changed and those people are indeed excluded from the major portion of the break.

Mr. **Chapoton**. Let me emphasize that the break is not designed for the lessor. The break is designed for the user of the equipment. The lessor does not put equipment in place, is not utilizing equipment in a productivity sense, but he is simply making the tax benefits available to the business that does put the equipment in place.

Senator **Nunn**. There must be some benefit to the lessor that is pretty substantial. Otherwise you would not have any lessors.

Mr. **Chapoton**. He has an investment opportunity like any other investment opportunity he may have and he will make a return on that investment. You are correct that a small closely held business now and even with this change an individual business would be denied this investment opportunity.

While we think the at-risk rules probably should not apply to the closely held corporations, I think we would be very reluctant to do away with the at-risk rules in the individual sector because you have rate differentials. It would not by any means be limited to businesses if you did that. It would be allowed to individuals up and down the line and I think that probably would not be desirable.

Senator **Nunn**. Do you know what it would cost to replace safe harbor leasing with a refundable tax credit?

Mr. **Chapoton**. The benefits of leasing apply to both the credit and the deductions. If refundability were used, it would probably be limited to the credit. Therefore, the revenue costs would be diminished because the ACRS deductions would not be refundable.

Senator **Nunn**. It would be less than $30 billion then?

Mr. **Chapoton**. It would be less than $30 billion, yes. It would be considerably less. I do not have a figure.

Senator **Nunn**. Would you have any idea? Are we talking about maybe a $20 billion loss rather than $30 billion, or are we talking about a $10 billion loss?

Mr. **Chapoton**. Senator, I am reluctant to say. It would cut it considerably.

Senator **Nunn**. Could you furnish that for the record?

Mr. **Chapoton**. Yes; I will furnish that. I guess the easiest way to do it is if only the credit were available for some form of transferability or refundability. Yes; we will furnish that for you.

Senator **Nunn**. You could cover small business if you did that without causing any administrative problem, could you not?

Mr. **Chapoton**. Yes, we certainly could. However, if refundability is involved, the lessor or purchaser would not be involved at all in any event. It would only be the user of the equipment who would be the party concerned.

Senator **Nunn**. Really, if you talk about the loss to the Treasury and the overall benefit to business, you would save a considerable amount of money to the Treasury while retaining the essential benefits and perhaps broadening those benefits on a more equitable basis by making it refundable rather than the way we have it now. Is that right?

Mr. **Chapoton**. No, you would not broaden the benefits at all. All the present——

Senator **Nunn**. I mean broaden it by having more people participate. That is what I am saying.

Mr. **Chapoton**. No; you see, the lessees, the users of equipment, all can utilize the present rules. With refundability, the same parties would be able to utilize refundability. The restriction we are talking about is only on the lessor side. If you converted to a refundability system, the lessors would be out of the picture altogether. You would not have that concern. The same users would have the benefits, but the benefits would be reduced because you would be denying the benefits of the accelerated cost recovery deductions and limiting the benefits to the credit.

Senator **Nunn**. Of course the difference is that the small businesses under the present situation, even those that are eligible, have a very hard time paying the up-front cost of accounting and legal fees to get this done. They would not have that problem with refundability, would they?

Mr. **Chapoton**. They would not have that problem with refundability. We reviewed refundability when this matter first came up. There are an awful lot of problems in determining how you decide a taxpayer is eligible for refundability. Do you audit in advance or do you just send a check for anybody who writes in and claims they have made an investment? The administrative problems would be great.

Senator **Nunn**. I am not arguing for refundability, except I think it makes a lot more sense than what we have now. I do not like a system where most of small business is precluded either by regulation or precluded by the practicality of the fact that they do not have enough money to pay for the accounting and legal fees.

It just seems to me that when you look at the statistics in this country, where the growth came in jobs, came from over the last decade and when you look at where the innovation came from and when you look at the heart of our economy, you basically are excluding them from a very important tax provision as a practical matter.

Mr. **Chapoton**. Senator, small business has used the old leasing rules for years. I simply do not accept the proposition that small business users of equipment will not utilize the safe harbor leasing rules and are not utilizing them. I think they are and I think their use will continue to grow.

Senator **Nunn**. The average small business employs about 9 to 11 people and has gross receipts of between $600,000 and $700,000 a year and makes capital expenditures of somewhere between $25,000 and $30,000. Do you really believe that that kind of small business can ever utilize these leasing provisions?

Mr. **Chapoton**. Absolutely. Whether they have done it to date on transactions of $10,000 and even smaller in range, by and large those will depend, as in every case of a financing arrangement, on standardization of the documents. The transaction costs in any type of financing arrangement are high in relation to the cost of the smaller transaction.

As the transactions become more standardized, there is every reason. There is no reason to think that the small businesses in smaller transactions would not utilize them.

Indeed, as I pointed out, over 95 percent of these transactions, whether small business or large business, the transaction costs are the same in relation to the investment in the transaction whether it is for a small business or a big business. Somebody is deciding it is worth the transaction cost in 95 percent of these transactions for deals under $100,000.

Senator **Nunn**. Have you tried to calculate how much permanent damage is going to be done to the image of the private enterprise system by reason of what is a growing perception of unfairness and inequity in the leasing provisions?

Mr. **Chapoton**. That is a concern to me, Senator. The possible damage to the self-assessment tax system is, I think, a legitimate concern that the tax writing committees and we must address. For the reasons I have stated we think the leasing rules are sound, but when there is a sound economic and a sound investment incentive, when the perception develops as is developing with respect to the leasing rules that it is unfair, certainly that is a concern that should be addressed and which we are looking at very directly.

Senator NUNN. I think there is even a case to be made, although I have not reached a conclusion, that at some point when we get in better economic shape we should consider abolishing the corporate income tax. We certainly could not do it now. It would be a different case altogether and it would be explained to the people of the country in an equitable and fair way.

If we are doing it by the back-door method, particularly for larger businesses while smaller businesses cannot, I see a real uprising, not just a populous uprising but an uprising by large segments of the free enterprise system itself against this kind of inequity. That is what concerns me. I think the Treasury ought to consider that very strongly. I am glad to hear you are considering it.

Mr. CHAPOTON. We are considering it. I will state once again that the perception of the fairness of our system is a very important part of our system.

Senator NUNN. Have you considered whether the farmers in this country are eligible? Farming is one of our very important segments of small business. Do you know how many farmers are incorporated?

Mr. CHAPOTON. I would say relatively few small farmers are incorporated, but we might add that some of these transactions involved tractors. The farmer could use the benefits if he is the lessee, the user of the equipment, without regard to whether he is incorporated.

Senator NUNN. Could you just walk us through how an unincorporated farmer could use this?

Mr. CHAPOTON. The farmer wants to buy a tractor and the tractor costs $20,000. He has no current taxable income. Then the tax benefits would be of no use to him. He would make an arrangement when he buys the $20,000 tractor to enter into a safe harbor lease with another entity, a corporation. Normally in that situation it would be a bank.

He would then sell, for tax purposes, the tractor to the bank. The bank would pay him approximately 25 or 22 percent of the initial cost of the tractor at the time of the closing of the transaction. The net cost of that tractor would drop by over 20 percent to the farmer. He would have no further tax benefits while the bank would immediately or simultaneously lease that tractor back to the farmer.

The farmer would then have no further tax benefits from the use of that equipment, but the bank would. The effect would obviously be that the farmer has just paid 20 percent for that tractor.

Senator NUNN. Sometime I would like you to come down to the State of Georgia and first of all tell our farmers where you can find a $20,000 tractor and next explain to them this transaction and watch the amazement and puzzlement on their faces as you walk them through this. I would venture to guess to say that even 4 or 5 years from now that 90 percent of the farmers in America will not be taking advantage of this.

Mr. CHAPOTON. I would be puzzled why the implement dealer who wants to sell the tractor would not be aware of it and would not educate the farmers and have the banks standing by.

Senator NUNN. That will be interesting to see. I know one thing. We have plenty of farmers who cannot take advantage of tax losses these days.

Senator D'AMATO. I think Senator Nunn makes a good point. I think the perception, as I said to you before, of this sale-and-lease arrangement is it is one that benefits substantially the large corporate sector of America, that is healthy or relatively healthy, despite the fact that the kind of opportunities it offers for the small business entrepreneur, including the farmer, are very real and very substantial.

However, we have done a very poor job in getting this information to the business community, particularly the small business community. Indeed, as I learned while reviewing in detail the practical effects of the leasing opportunity with staff, I think Senator Nunn's questions concerning farmers are relevant.

Not only are their farmers in Georgia, but there are quite a few farmers in upstate New York. They are having great difficulty in making the kind of capital investments that are necessary for new equipment. In talking about the grape industry, that equipment goes for over $100,000. Here is an opportunity where they can recoup at least 20 percent, or get $20,000 back in a cash infusion.

Whether or not it is the equipment dealer himself who puts together this package and can induce the lessor's participation, I believe it can be a very real tool for the small businessman and we have to do a lot more in making this information available.

As Senator Nunn has pointed out, there are very few farmers and people in the small business area who are aware of the kinds of benefits that are available.

Let me ask you this. Just last month the chairman of the Finance Committee, Senator Dole, indicated that they would be looking to repeal the safe harbor leasing provisions. Consequently, there seems to have been a total cessation of tax leasing activity.

Is that a fair estimate on my part to say there has been a total cessation? Are the windows closed?

Mr. CHAPOTON. I really do not know whether there has been a total cessation. There has clearly been a very big dent in the leasing activity as a result of his statement that any changes would be effective that date of 1 week ago Friday.

Senator D'AMATO. How important does the administration and the President feel that the tax leasing provision is in terms of their overall economic recovery program?

Mr. CHAPOTON. As we have stated on a number of occasions, Mr. Chairman, we feel it is very important. It is an integral part of the accelerated cost-recovery system. We think that one should look very carefully before cutting back on the leasing provisions, much less repealing them, particularly this year when we are in a recession and we need every encouragement we can give.

Senator D'AMATO. I have some other questions that get into some detail. I would like to submit them to you as a written followup to this hearing. There seems to be a growing controversy in regard to the applicability of using Federal transit funds in this program and that the Federal portion in terms of the sale and leaseback for mass transit cannot be taken advantage of in the traditional sense, lessor/lessee, as a tax credit transferred from the MTA. Is that correct?

Mr. CHAPOTON. That is correct. To the extent Federal funds are provided, no tax benefits are given. That is a rule normal in tax law, but tax leasing in mass transit is available with respect to the funds furnished by the local government.

Senator D'AMATO. What we are saying is that the local funds that come from the communities or States can be used in this program, but the Federal funds will be precluded. Is there an existing IRS rule on that today?

Mr. CHAPOTON. Yes, sir, that is correct.

Senator D'AMATO. Maybe you could do an analysis on the impact of this because this has been raised before us?

Mr. CHAPOTON. All right.

Senator D'AMATO. Senator Nunn?

Senator NUNN. I just have one more question, Mr. Chairman.

Mr. Chapoton, will the President veto a repeal of the leasing provision if it passes Congress?

Mr. CHAPOTON. Senator Nunn, I simply could not speculate on that.

Senator NUNN. What about Treasury's advice to the President?

Mr. CHAPOTON. Treasury's advice would be to support the leasing provisions. You would have to see what type of bill it is on, but we would certainly advise supporting the leasing provision to every extent possible.

Senator NUNN. Including a veto if it is feasible?

Mr. CHAPOTON. If the bill were simply a bill repealing leasing, then surely we would recommend a veto.

Senator NUNN. Therefore any effort on repealing leasing probably should be tied to the debt ceiling bill, right?

Mr. CHAPOTON. That would be a judgment at this end of the street, Senator.

Senator D'AMATO. Now you know where the attack is going to come from.

Thank you very much, Mr. Chapoton.

Mr. CHAPOTON. Thank you, Mr. Chairman.

[The prepared statement of Mr. Chapoton and subsequent information follow:]

For Release Upon Delivery
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STATEMENT OF
THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS

March 2, 1982

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). As you know, I appeared before the Senate Finance Committee and the House Ways and Means Subcommittee on Oversight last December and discussed in great detail the purpose and design of the leasing rules. I have brought with me a copy of that testimony and I request that it be entered in the record of this proceeding.

I will not repeat everything that I said in my earlier testimony, but I would like to reemphasize certain fundamental points about leasing in general, and as it may apply to small business in particular. At the outset, I would like to make it absolutely clear that we stand firm in our conviction that leasing is a necessary part of the President's tax program. We recognize that we have an uphill battle in educating the public on the merits of leasing, and we certainly welcome this opportunity to appear before you today to explain the purpose for the rules and to answer any questions you may have.

Background

As I indicated, the leasing rules are an integral part of the President's tax program to restore economic growth. Every lease is associated with spending for new equipment and much of this spending would not have otherwise occurred. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

"Safe harbor" leasing allows all companies, large and small, full access to the incentives in the recent tax bill for making new investments. Without these rules, there will be unequal competition for funds, new companies will face additional financial barriers, and there will be increased pressure for tax-motivated mergers and takeovers. Moreover, as I will discuss hereafter, we expect any additional financial burdens that would arise in the absence of leasing to fall heavily on small business.

The Investment Incentives of ERTA

To see the need for leasing, the operation of the investment incentives of ERTA must be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. The acceleration of deductions effectively lowers the cost of buying new equipment and thereby raises the after-tax rate of return on that investment.

This increase in the after-tax return is the primary investment incentive of the President's tax program. A problem arises, however, when these accelerated deductions become available at a time when the new equipment is producing little income. In that case, the deductions will serve their purpose only if they can be used to offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to a firm that is able to use them, the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans; and firms with temporary losses, but profitable investment opportunities. Additionally, the more rapid write-offs for cost recovery under ACRS will moderately increase the number of currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

How Leasing Works

As an illustration of how a company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco, making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed to claim deductions under ACRS of $37,000 and an investment credit of $10,000. To use all of these tax benefits, Newco would need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from other assets, Newco would have to postpone using some or all of the ACRS benefit, which, in turn, may make Newco's after-tax return on the new investment less than that of its competitors. Stated otherwise, Newco's return from that investment would be lower than that of corporations which, for various reasons unrelated to the investment, may be able to use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms like Newco to invest in new equipment even though their investments have not yet produced large profits. With leasing, Newco has the option of retaining the ACRS deductions and credits, or it may sell the tax benefits associated with the equipment to another corporation. This allows Newco to use the equipment in its business and, at the same time, permits it to enjoy the benefits of the investment credit and accelerated deductions.

There are three important aspects of leasing which should be borne in mind. First, leasing creates no extra deductions or credits. The total deductions and credits taken by both parties to a lease transaction are the same as would have been taken if Newco had taxable income from other investments. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative (but much less desirable) way to accomplish the same result would be by an actual merger of Newco with a mature company wishing to reduce its tax liability.

Second, virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, in our case, Newco. This is because the purchasing company, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for the tax benefits is becoming very competitive. From our preliminary analysis of a small sample of sale and leaseback transactions closed in 1981, we have found that a high percentage of the tax benefits from leased property are being passed through to lessees. This percentage should increase as safe harbor leases become routine market transactions.

This is an important point because it means that the investment incentive inherent in ACRS remains where it should be, namely, in the hands of the firm that will undertake the new investment and employ the new equipment. Although the purchasing company claims the credits and ACRS deductions on its tax return, it pays for those credits and deductions. With this payment, and the tax saving from the excess of its rental payments over its interest receipts from the purchasing company, Newco can ultimately receive virtually all the benefits of ACRS.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not foster uneconomical or tax-motivated investments. Even with the lease agreement, Newco makes a substantial investment in the asset, and the income that asset generates will be taxed. Unless the asset produces sufficient income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as is provided to firms with taxable income. With those incentives equally available, firms are able to select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Leasing and Small Business

We are well aware of the various bills that have been introduced to repeal the leasing provisions. We are also mindful of the size of the projected budget deficits and the thought that a repeal of leasing would help to alleviate that deficit. While the repeal of leasing would reduce the revenue loss in the short run, we believe that in the longer term, its repeal would do much to undercut the investment incentives adopted by the Congress last year as part of ERTA. As a result, investment in new plant and equipment would decline with a concommitant reduction in economic activity. If leasing is repealed, we expect much of the impact would fall on small business.

As I mentioned earlier, leasing is intended to help those firms which cannot fully utilize the tax benefits associated with new investments in plant and equipment. A typical firm in this category would include a new firm or a firm which does not have sufficient income from other assets to absorb the tax benefits. Firms in these categories are usually smaller companies. The ability of these firms to sell their tax benefits is an important source of financing, particularly in these times of tight money and high interest rates. This is especially important for small businesses because they typically finance their operations from current earnings or from borrowings, and tend to rely less on equity financing.

Thus, in relative terms, the retention and utilization of safe harbor leasing is at least as important to small companies as it is to larger ones. In this connection, while most of the attention on leasing has been on the reported transactions that have thus far been closed between large companies, we do not think that this is indicative of the entire class of companies that have or will benefit from leasing.

We understand from informal discussions with investment bankers and lawyers that because of the November 13, 1981 deadline for closing initial transactions, and because of the newness of the legislation, many brokers refused to consider small leases. The complexities of the legislation and the transactions made closing costs high and small leases uneconomical. However, we now understand that as the leasing industry becomes more familiar with the rules and the lease documents become standardized, lease brokers are turning their attention to smaller leases. This should make leasing available to all companies on an equal basis.

In addition, the information we have gleaned from the lease information returns indicates that many smaller companies have been able to use the leasing rules effectively even without the aid or assistance of large professional brokers and investment bankers. The nearly 16,500 lease information returns filed with the IRS through the beginning of last week represent an estimated 14,500 lease transactions. (Some transactions, particularly the large ones, involve multiple leases.) Of these transactions, fewer than 500 represent agreements involving property worth more than $1 million. The remaining 14,000 transactions, or over 95 percent of the total, cover property worth less than $1 million. Most of these smaller transactions cover property worth less than $100,000, and involve "straight" or "leveraged" leases, that is, leases in which the lessee does not "sell" the property to the lessor.

We have not yet analyzed the data we have received on straight lease transactions, but we anticipate that the same positive benefits would flow to a user of equipment in those types of transactions that we are finding under a sale and leaseback arrangement. Many small companies lease their typewriters, copying machines, office furniture, automobiles, etc. Before safe harbor leasing, the savings realized by these companies through leasing versus buying the equipment depended in large part on the uncertain value of the property at the end of the lease term. By eliminating the need to take the value of the residual into account, the safe harbor rules have made leasing more efficient. As a result, more of the benefits of leasing should pass through to the users of the equipment. Note that many such leases would have taken place in the absence of the safe harbor rules, but would have been less beneficial to the lessees.

As I noted earlier, we have completed a preliminary analysis of a small number of sale and leaseback transactions. Our analysis indicates that about 88 percent of the tax benefits of leased property are being passed through to, or retained by, the users of the equipment. Although this sample is too small to generalize, and does not include any straight leases, it does indicate that the percentage of benefits passed through are about the same regardless of the size of the lease. Further, the benefits appear to pass through fairly uniformly over industries.

We are currently analyzing the remaining lease information returns and should be able to provide the Committee with additional data on the effect of leasing on small business within the next few weeks.

Leasing and the "At Risk" Rules

Before concluding my remarks, I would like to comment on one aspect of the leasing regulations that has drawn criticism from some small business groups, namely, the application of the "at risk" rules to leasing transactions.

Code section 465 limits the amount of losses that certain closely held companies may deduct with respect to an activity to the extent of the amount they have at risk in that activity. The concept of at risk was introduced in the Tax Reform Act of 1976. It was basically a measure to restrict tax shelters by altering the timing of deductions, so that a taxpayer could not claim deductions in excess of the amount of cash and recourse debt that he had invested in an activity at the end of any year. At risk has nothing to do with the calculation of deductions; it affects the timing of deductions by matching them dollar for dollar with the taxpayer's investment. As his investment increases, a taxpayer is allowed to claim excess deductions that have been suspended from earlier years when his investment was small.

Individuals, subchapter S corporations, and closely held businesses (in which five or fewer individuals own at least 50 percent of the stock) are subject to at risk. At risk now applies to all activities, including leasing of depreciable property. Leasing companies that meet certain requirements as to the volume of their business are exempt from at risk. In general, companies that enter into safe harbor leases will not qualify for this special exception.

The Economic Recovery Tax Act of 1981 extended the at risk rules to the investment tax credit. Although the at risk amount for the investment tax credit is separate from the at risk amount for ACRS and other deductions, it is similarly measured by the cash and recourse debt with which the property has been financed.

A taxpayer's amount at risk includes cash investments and recourse debt, as long as these amounts are not guaranteed against loss or borrowed from a related person or a person who has an interest in the activity other than as a creditor. Nonrecourse debt is counted in the at risk amount only as it is paid off.

Except in the case of a subchapter S corporation or a personal holding company, the new leasing rules do not expressly prevent closely held companies from engaging in leasing transactions. However, the regulations do provide that the at risk rules apply in determining the amount of deductions and credits a purchaser of tax benefits, i.e., a lessor, may claim. Because of these rules, any safe harbor lessee or lessor that is subject to the at risk rules will have restrictions placed on the timing of both the ACRS deductions and the investment credit that are generated by the lease. This means that some closely held companies may be effectively excluded from safe-harbor leasing by operation of the at risk rules.

In a speech I delivered last October, I indicated that the at risk rules may not apply to closely held lessors in safe harbor leasing transactions. In developing the regulations, however, we concluded that the leasing regulations could not add an exception to the at risk statute without express statutory authority.

Various people representing the small business community have suggested that the leasing provisions should be amended to relax the at risk restrictions as they apply to safe harbor leasing transactions. With respect to the application of the at risk rules to the activity of the user of equipment, i.e., the lessee, we would strongly oppose any amendment which would exempt a lessee from at risk if it would otherwise be subject to those rules. Closely held businesses that are lessees should not be able to pass through the fully accelerated effect of ACRS deductions on the leased property or the full credit in the first year of the lease if the lessee would have been otherwise precluded from claiming the deductions and credit on its own return by virtue of the at risk rules. The effect of such an amendment would be to emasculate the at risk rules altogether.

A relaxation of the at risk rules as they apply to lessors in leasing transactions, however, involves different considerations. Initially, we question the need for such an amendment.

The cash flow generated by the accelerated write-offs and credits allowed under ACRS are intended to stimulate investment by reducing a firm's effective cost of capital. The incentive is lost, however, where a firm has no positive tax base against which it may use the tax benefits. Leasing is intended to restore that incentive in those cases by allowing a company to sell the tax benefits with respect to a new investment in equipment. While it is true that a lessor will presumably earn a positive return from investing in a leasing transaction, that return should be no more than that available elsewhere. The real beneficiaries of the new leasing rules are (and should be) the lessees, that is, the users of equipment which are selling the tax benefits. To that end, closely held companies are not disadvantaged by the regulations. Under the statute, anyone may be a lessee, including individuals. Although the at risk rules are applicable to lessees as well, this should not be a significant problem since we would expect most lessees which are small businesses will be at risk in their investments anyway.

Moreover, any profit earned by a lessor on a leasing transaction is payment to the lessor for advancing the money to the lessee for the ACRS deductions and credits to which the lessee was otherwise entitled. The effective exclusion of closely held companies as lessors discriminates in favor of large companies only to the extent that large companies have an additional investment option available to them. It certainly does not mean that closely held companies are denied the benefits of leasing.

It has been suggested that an amendment to ease the at risk rules is needed because small companies will only deal with other small companies. Thus, if small companies are prevented from entering leasing transactions as purchasers of tax benefits, many small companies as sellers of tax benefits will be unable to take advantage of the leasing provisions.

We question whether there is any natural hesitancy on the part of small companies to deal with large companies in a leasing transaction. Moreover, as I have indicated, we fully expect that lease brokers will be able to package the leasing of equipment to make the leasing of small amounts of equipment attractive to large companies.

On the other hand, we would agree that since the leasing provisions are market-oriented, there is no reason to curtail the universe of potential lessors by discriminating among corporations that are allowed to be lessors. Also, we are satisfied that there are sufficient safeguards within the leasing rules that a change in the at risk rules as they apply to lessors would not open any abuse the at risk rules were intended to prevent. At risk was intended principally to prevent individuals, partnerships, and closely held companies from artificially overstating the depreciable basis of their assets through the use of nonrecourse debt. It would not be possible to circumvent this purpose through a leasing transaction as long as the lessee continues to remain subject to at risk. This is because the timing and amount of the lessor's deductions may not exceed the deductions and credits that would be available to the lessee had the lessee not entered the lease in the first place.

Although we have doubts that an amendment to relax the at risk rules as they apply to lessors would have any appreciable affect on the benefits of leasing flowing to small companies, we would not oppose carefully developed legislation along those lines. However, before giving our approval to any such amendment, we would want to take a close look at the proposal as there may be special circumstances where we would not want the at risk rules modified.

Summary

It is not surprising that the celebrated leasing transactions have been those involving large, well-known corporations. These make news. But the safe harbor provision is especially important to the growth and continued independence of small businesses. Small businesses are already using the provision and many more will benefit from it, if the Congress does not overreact to publicity from a few unusual cases.

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DALE BUMPERS, ARK.
JAMES R. SASSER, TENN.
MAX BAUCUS, MONT.
CARL LEVIN, MICH.
PAUL E. TSONGAS, MASS.
ALAN J. DIXON, ILL.
ROBERT J. DOTCHIN, STAFF DIRECTOR
R. MICHAEL HAYNES, CHIEF COUNSEL
ALAN L. CHVOTKIN, MINORITY CHIEF COUNSEL

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

March 17, 1982

Mr. John E. Chapoton
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, N. W.
Room 3120
Washington, D. C. 20220

Dear Mr. Chapoton:

In follow up to the Senate Small Business Committee's March 2, 1982 hearing concerning Safe Harbor Leasing, we would appreciate it if you would provide responses to the attached questions for the hearing record.

Because it seems that Safe Harbor Leasing will be reconsidered by the Senate in the very near future, it is important that the information requested be made available to us as soon as possible.

Thank you for your timely consideration.

Sincerely,

SAM NUNN
Ranking Minority Member

LOWELL WEICKER, Jr.
Chairman

ALSONSE M. D'AMATO
United States Senator

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

APR 26 1982

Dear Mr. Chairman:

I am writing in response to the March 17 letter from you and Senators Nunn and D'Amato concerning safe harbor leasing. In your letter, you requested responses to a list of questions to be included in the record of the March 2 hearing at which I testified. Responses to most of those questions are enclosed. We are performing the additional analyses required to answer the remaining questions. I will send you those answers when they are completed, which should be within the next two weeks.

I am sending a similar letter to Senators Nunn and D'Amato.

Sincerely,

John E. Chapoton
Assistant Secretary
(Tax Policy)

The Honorable
Lowell Weicker, Jr.
Chairman of the Committee
on Small Business
United States Senate
Washington, D.C. 20510

Enclosure

Questions from the Senate Committee on Small Business Concerning Safe Harbor Leasing

1. Question:

Please provide the Committee with a breakdown of the leasing transactions reported to date on IRS Form 6793 by company size for both the lessor and lessee. We suggest this information be reported as follows:

First, a frequency distribution by transaction size. The breakdown should be detailed enough so that the frequency of small transactions can be ascertained. This information can be obtained from data reported on Form 6793.

Second, a frequency distribution by company size, both by lessor and lessee. This data can be obtained by using the taxpayer identification number reported on line 3 of Form 6793 to "pull" the most recent tax returns for the businesses involved. From the tax returns, gross sales and total assets can be obtained. Please provide frequency distributions by both gross revenues and total assets. Again, the breakdown should be detailed enough so that the frequency of small companies engaged in Safe Harbor Leasing can be ascertained.

Third, because the second item above will likely take time, it is requested that a random sample be taken of 50 or 100 information returns (Form 6793) showing Safe Harbor Leasing transactions of $100,000 or less. The tax returns of the lessors and lessees chosen in the sample should be pulled and frequency distributions prepared based on the gross revenues and total assets of the companies sampled.

Answer:

With respect to the first part of the question, a frequency distribution by transaction size is shown in Table 3 of the attached Treasury report entitled, "Preliminary Report on Safe Harbor Leasing Activity in 1981." The total number of 1981 safe harbor lease transactions shown in Table 3 was 11,902, of which 7,544 or 63.4 percent involved leased property valued at less than $100,000, and 11,211 or 94.2 percent involved leased property valued at less than $1 million. It should also be noted from Table 3, however, that 85 percent of the dollar value of all leased property was included in transactions in excess of $10 million.

With respect to the second part of the question, we are currently preparing an extract of data, including gross receipts and assets, for all companies involved to date in safe harbor leasing from the Business Master File (BMF). This extract will then be linked to data from the Safe Harbor Lease Information Returns (Forms 6793). The linked data will then be cross-tabulated by size of firm and size of lease transaction. Results from these cross-tabulations should be available within the next two weeks.

The third part of the question suggests that we try to link 50 or 100 Forms 6793 covering small transactions to firms' income tax returns. The number of returns suggested for linking could be too small to provide statistically reliable results. (For example, a table with ten company size classes and only one size of transaction class would have 10 cells; with 50 returns there would be, on average, only 5 returns per cell and many cells would have fewer than 3 returns. Cells with fewer than 3 returns can generally not be made publicly available because they might disclose the identity of a taxpayer.) Further, "hand" pulling tax returns is much more expensive than is the BMF extract we are preparing. The BMF extract will be available in the near future. It will provide statistically reliable data suitable for public release and is much more cost-effective. Therefore, we are not planning to "hand" pull any returns.

2. Question:

Please provide the mean and the median third-party transaction cost as reported on line 12 of Form 6793 as a percentage of transaction size. Please provide these measures for all transactions less than $100,000, $100,001 to $500,000, and $500,001 or more.

Answer:

Data in Tables 3 and 6 of the attached Report allow computation by transaction size, of the ratio of third-party fees to either the value of leased property (Table 3), or, for "wash" leases only, the total tax benefits from the leased property. The latter ratio is shown as the next-to-the-last column in Table 6. Third-party fees as a percent of total tax benefits from the leased property are lower than average for wash transactions of less than $100,000, but higher than average for transactions of between $100,000 and $1 million. Similarly, from Table 3 it can be computed that for all leases, third-party fees as a percent of the value of leased property are lower than average for transactions of less than $100,000, but somewhat higher than average for transactions of between $100,000 and $1 million. The above figures are, of course, mean ratios. We have not yet computed median ratios, but will be doing so when we analyze a much larger sample of 1981 Forms 6793. We expect to complete this analysis, and will provide you with these results, within two weeks.

3. Question:

Please provide an estimate of the revenue losses (FY '82-FY '86) that would occur assuming that Safe Harbor Leasing is repealed as of February 19, 1982, and replaced with a refundable ITC (no refund of depreciation).

Answer:

The estimated revenue impacts are as follows:

	Fiscal Years				
	1982	1983	1984	1985	1986
	($ billions)				
Gain from repeal of leasing 2/19/82	1.1	3.1	5.0	7.1	9.3
Loss from refundable ITC	-5.0	-16.0	-14.0	-15.5	-19.3
Net Loss	-3.9	-12.9	- 9.0	- 8.4	-10.0

4. Question:

There was considerable discussion at the March 2 hearing concerning "pooling" or "packaging" of small leasing deals. Please prepare a report on activity in this area. Also, are there practical problems that prevent pools of small lease deals from being formed? If so, what is the source of the problem? What needs to be done legislatively to make it possible to pool small lease deals?

Answer:

As indicated in the responses to Questions 1 and 2, most 1981 lease transactions were quite small (nearly 95 percent involved less than $1 million in property) and third-party fees, relative to the size of transactions, appear to be comparable for small and large transactions. These facts indicate that there are no real barriers to leasing by small companies. The "pooling" or "packaging" of small lease transactions can help provide more of the benefits of safe harbor leasing to small companies by further reducing transactions costs and assuring that the safe harbor lease market works smoothly and efficiently.

It is our understanding that the packaging of small lease transactions is not beset with any serious practical problems. There is already some activity in this area, such as the E. F. Hutton plan (see attachment). In addition, some lessors have developed plans that are specifically aimed at small businesses. For example, John Deere and Allis-Chalmers have leasing plans for farm implements (see attachments). More packaging of small transactions and small business plans will develop over time if the legislative uncertainties surrounding safe harbor leasing are dispelled.

5. Question:

Please provide an estimate of the additional revenue losses that would occur if, in addition to regular corporations, closely-held corporations, Sub. S corporations, partnerships, proprietorships, etc., were made eligible to participate as lessors in Safe Harbor Leasing transactions. (Assume Section 465 would not apply to any lessor in a Safe Harbor Lease.) Also, please provide a discussion as to the advantages and disadvantages of allowing anyone to be a lessor in Safe Harbor transactions. Would such a change increase the benefits of Safe Harbor Leasing to small businesses?

Note: Please include all assumptions involved in calculating revenue losses.

Answer:

While anyone, including individuals, may be a lessee in a safe harbor leasing transaction, the statute expressly limits the universe of potential lessors to corporations, other than personal holding companies or subchapter S corporations. Personal holding companies were excluded from the category of lessors to prevent them from sheltering investment income through a leasing transaction. To permit them to be lessors would circumvent the intent of the personal holding company provisions.

Individuals, partnerships, and subchapter S corporations were excluded for several reasons. First, the maximum rate of tax on the income of an individual is 50 percent while corporations pay tax at 46 percent or less. If the statute permitted individuals to be lessors, many lessees would engage in rate arbitrage by selling their deductions, which could be used to offset income taxable at 46 percent or less, to an individual who could use the deductions against income taxed at 50 percent. In these cases, lessees would be receiving more for their tax benefits than they would if they had used the deductions against their own taxable income.

There are also perception and compliance problems with permitting individuals to participate in safe harbor leasing transactions as lessors. There is concern that a leasing transaction might be perceived by the general public as merely a tax shelter device for wealthy individuals, a perception that would undermine our voluntary tax system. From a compliance aspect, in the past the IRS has had significant problems with individuals who invest in tax shelters and claim the deductions generated in the early years, but fail to report the income in the later years. The same potential for noncompliance would exist in the case of individual lessors.

But aside from the problems noted, we are not sure that there is any reason to allow individuals to act as lessors. The leasing rules were designed to help lessees, that is, the users of the equipment which are selling the tax benefits. The primary role of a lessor is to see that the lessees receive payment for their tax benefits. From a lessor's perspective, a leasing transaction merely represents an additional investment opportunity. Since there are currently a sufficient number of lessors to absorb the tax benefits that could be sold by lessees, there appears to be no need to expand the universe of potential lessors to include individuals.

6. Question:

Please provide an estimate of the additional revenue losses that would occur if, in addition to depreciation deductions, an ITC on a domestically-produced qualified mass commuting vehicle is allowed to a lessor in a Safe Harbor lease.

Note: Please include all assumptions involved in calculating revenue losses.

Answer:

A provision of the Internal Revenue Code that allowed an investment tax credit only for domestically-produced qualified mass commuting vehicles would violate the General Agreement on Tariffs and Trade (GATT). Specifically, paragraph 2 of Article 3 of the GATT provides, in part, that "the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products." Since the purchaser would not receive the proposed investment tax credit for the purchase of an imported mass commuting vehicle, and therefore be taxed at a higher rate than on a domestically-produced vehicle, the proposal would violate this section of GATT.

In addition, paragraph 4 of Article 3 provides that "the products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use." The proposal also would violate this GATT provision because it would not accord to imported mass commuting vehicles "treatment no less favorable than that accorded to like" domestic mass commuting vehicles "in respect of all laws...affecting their internal... purchase."

7. Question:

Please provide a list of all Safe Harbor Leasing transactions involving qualified mass commuting vehicles reported to date on Form 6793. It should be possible to identify "transit" lessees from data reported on line 3b of Form 6793. The list should identify the lessee and show the value of the transaction.

Answer:

Under section 6103 of the Internal Revenue Code, disclosures of taxpayer information, except in carefully circumscribed situations, are prohibited. A list of safe harbor lease transactions involving mass commuting vehicles would involve the disclosure of taxpayer information, i.e., the names of taxpayers associated with tax returns, and therefore is prohibited under section 6103.

However, as part of our analysis of a larger sample of 1981 Forms 6793 we will develop additional statistical information on mass commuting vehicle leases. We expect to complete this analysis and will provide you these results within two weeks.

Attachments

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
March 25, 1982

Contact: Charles Powers
566-2041

Statement by Donald T. Regan
Secretary of the Treasury
Safe Harbor Leasing

There has been much debate about the safe harbor leasing provision of the Economic Recovery Tax Act of 1981. In order to enhance the discussion and encourage informed review of this important issue, we are releasing preliminary information on total 1981 safe harbor leasing activity. Our information is based on a representative sample of 2000 leases. When a larger sample has been analysed, additional information will be released.

Overall, our analysis indicates that the value of leased property in 1981 totaled $19.3 billion, very close to the figure upon which we based our initial revenue estimates. In addition, most of the tax benefits from leased property, about 84 percent, go to the lessee, while 15 percent is retained by lessors with the remaining one percent covering transaction costs to third parties.

Over 85 percent of the dollar value of all leased property was involved in transactions in excess of $10 million. More than 60 percent of the number of actual lease transactions, however involved less than $100,000 of property, and nearly 95 percent involved less than $1 million of property. Transaction costs for small lease arrangements appear to be no larger, relative to the size of the transactions, than they are for large lease transactions. These facts indicate that there are no real barriers to leasing by small companies.

Finally, companies in mining, oil and gas drilling, lumber and paper, chemicals, airlines, primary metals, motor vehicles, railroads, shipping and utilities were major lessees. This list includes most of those industries that have been considered "distressed."

Safe harbor leasing is a significant element in this Administration's effort to increase growth and productivity in the economy and provide jobs. It is a realistic attempt to provide equal incentives to invest to all firms. If our further study indicates the need, we will propose modifications in the existing safe harbor leasing rules.

R-700

Department of the Treasury
Office of Tax Analysis
March 26, 1982

PRELIMINARY REPORT ON SAFE HARBOR LEASING ACTIVITY IN 1981

Summary

There has been much debate about the Safe Harbor Leasing provision of the Economic Recovery Tax Act of 1981. In order to enhance the discussion and encourage informed review of this important issue, we are releasing preliminary information on total 1981 safe harbor leasing activity. Our information is based on a sample of about 2,000 leases. When a larger sample has been analyzed, additional information will be released.

Overall, our analysis indicates that the value of leased property in 1981 totaled $19.3 billion, very close to the figure upon which we based our initial revenue estimates. In addition, most of the tax benefits from leased property, 84.5 percent, go to the lessee, while 14.2 percent is retained by lessors with the remaining 1.3 percent covering transaction costs to third parties.

Over 85 percent of the dollar value of all leased property was included in transactions in excess of $10 million. More than 60 percent of the number of actual lease transactions, however, involved less than $100,000 of property, and nearly 95 percent involved less than $1 million of property. Transaction costs for small lease arrangements appear to be no larger, relative to the size of the transactions, than they are for large lease transactions. These facts indicate that there are no real barriers to leasing by small companies.

Finally, companies in mining, oil and gas drilling, lumber and paper, chemicals, primary metals, motor vehicles, railroads, shipping, airlines, and utilities were major lessees. This list includes all those industries that have been considered "distressed."

Background

The Economic Recovery Tax Act of 1981 (ERTA) provided a new, more rapid method of depreciation, the Accelerated Cost Recovery System (ACRS), and expansion of the investment tax credit. These provisions will increase investment in plant and equipment, and thereby help to restore economic growth. The investment incentives provided by ACRS and the investment credit, however, are fully available only to a firm that can utilize them. Thus, for example, a new or rapidly growing firm that cannot currently use all of the ACRS deductions or all of the credit would have to defer their use. As with any deferral for which no interest is received, the deferral of tax benefits makes them worth less than a tax benefit available currently. Therefore, a new or rapidly growing firm or a firm with tax losses would receive less incentive from ACRS and the investment credit than would a firm that could fully utilize those tax incentives. Such a differential in tax benefits would put new, rapidly growing firms, and loss firms at a competitive disadvantage, would present them with additional financial barriers, and would make them targets for takeovers or mergers.

The safe harbor leasing provision of ERTA is designed to ensure that differentials in tax benefits do not arise. In a safe harbor lease, the lessee-user of the property can "sell" the property to a lessor, for which it receives a downpayment plus a note for the balance of the value of the property. This transaction is called a sale-leaseback. As tax-owner of the property, the lessor (which must be a corporation) claims the ACRS deductions and the investment credit for the property. The user makes an annual rental payment for the use of the property, and receives payments for interest and principal on the lessor's note. In most sale-leaseback transactions, the rental and debt payments are equal, so that no money, except the downpayment, is actually exchanged between the lessee-user and the lessor. The equal rental and debt payments are said to "wash," and therefore these transactions are called "wash" leases.

In an alternative safe harbor lease arrangement, the lessee-user is not the actual owner of the property. The lessor purchases the property from a third party, and then leases it to the lessee at an annual rental that is lowered by the tax benefits associated with the property. The lease may also carry an option to purchase at termination of the lease that is very favorable to the lessee-purchaser. These leases are referred to as "leveraged" or "straight" leases.

"Straight" leases were common under prior law for equipment with a ready resale market, such as airplanes, railroad cars, and oil rigs. But under prior law, lessors would generally not purchase highly specialized equipment for lease because it does not have a ready resale market, and prior law unduly restricted and complicated the lease transactions that did occur. As a result, leases under prior law required complicated agreements and legal uncertainties with attendant high transaction costs, including high legal and brokerage fees. These transaction costs reduced the amount of tax benefits received by lessee-users in the form of reduced rentals and more favorable purchase options. The new safe harbor provisions, therefore, in addition to allowing "wash" lease arrangements, have also made the traditional "straight" lease arrangements much more favorable to lessees who will use new equipment in production.

The remainder of this report presents data on, and analysis of, safe harbor leasing activity in 1981. The next section presents 1981 leasing data by the business activity of the lessee-user, the business activity of the lessor, and the size of lease transactions. The following section presents estimates of the efficiency of 1981 wash leases. The final section contains estimates of the revenue cost of the safe harbor leasing provision.

Data on 1981 Safe Harbor Leasing

The data on 1981 safe harbor leasing presented throughout this report are estimates of total activity in 1981 based on a sample of information returns (Form 6793) filed with the Internal Revenue Service. (A copy of Form 6793 appears at the end of the report.) The estimates are derived from a sample of 2,026 of these information returns, including virtually all of those for transactions involving $10 million or more of property. The number of the returns in the sample, and all money amounts that appear on them, have been multiplied by an appropriate weight so that they represent all of the 1981 lease returns. The data presented in this report, therefore, are estimates of total safe harbor leasing activity in 1981.

Tables 1, 2, and 3 show, for all leases and separately for wash leases, the number of leases, the value of leased property, and fees paid to third parties. Tables 2 and 3 also show the number of lease transactions. A lease transaction consists of all the leases between the same lessor and lessee. Most lease transactions consist of only one lease, but some transactions involve multiple leases.

Table 1 shows lease data classified by the industry of the lessee-user. In Table 1, each lease is classified by the activity of the lessee, even if the lessee is a corporation that is a member of a corporate group that is engaged predominately in another activity. For example, if the lessee is engaged in mining, the lease would be included in the figures for mining, even though the lessee may be a subsidiary of a railroad. Note also that each lease is classified separately in Table 1, even though it may be part of a multi-lease transaction. For example, if one lessor had leases with several subsidiaries of a railroad company, each lease would be classified by the activity of the subsidiary even though the leases, taken together, would constitute a single lease transaction.

The data in Table 1 indicate that major lessees are in mining, oil and gas extraction, lumber and paper, chemicals, primary metals, motor vehicles, railroads, shipping, airlines, utilities, and leasing. Many of these have been labeled "distressed" industries because many companies in these industries have recently been incurring losses.

Table 1

Preliminary 1981 Safe Harbor Lease Information by Business Activity of the Lessee

Business Activity of the Lessee 1/	All Safe Harbor Leases			Safe Harbor Wash Leases		
	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)
Totals	16,036	$19,331.9	$108.88	2,120	$15,432.9	$85.80
Agriculture	1,664	120.0	1.34	301	37.0	.67
Oil & Gas Extraction	837	850.7	6.56	140	710.8	4.66
Mining	283	615.9	4.23	155	514.0	3.36
Construction	864	218.4	1.49	47	98.8	.94
Manufacturing:						
Food & Kindred	223	119.5	1.01	29	73.4	1.01
Textiles and Apparel	106	41.2	-	4	28.1	-
Lumber and Paper	127	1,726.1	4.08	65	1,712.2	3.92
Printing	419	564.7	.03	14	1.5	.02
Chemicals	443	1,492.9	7.07	169	1,412.0	6.24
Petroleum Refining	40	435.6	2.75	13	425.5	2.50
Rubber & Plastics	110	296.9	.75	7	281.4	.42
Stone, Clay, & Glass	410	592.6	3.05	22	573.0	3.02
Primary Metals	70	1,309.5	4.47	46	1,282.8	4.47
Fabricated Metals	635	206.3	.74	81	133.2	.58
Nonelectrical Machinery	475	162.9	.48	8	88.5	.29
Electrical & Electronics	294	380.9	1.86	79	304.2	1.60
Motor Vehicles	18	1,123.8	3.51	18	1,123.8	3.51
Other Transportation Equip.	169	188.2	1.57	27	153.8	1.09
Other Manufacturing	182	64.7	.32	27	42.9	.14
Railroads	268	1,766.4	17.89	88	1,673.2	16.26
Other Motor Transportation	1,035	210.5	1.93	19	47.3	.69
Water Transportation	101	795.0	1.38	24	143.1	.50
Airlines	53	1,244.5	8.41	46	1,138.3	7.51
Other Transportation	32	174.8	.87	6	35.7	.14
Communications	268	450.3	5.42	142	348.0	2.42
Utilities	96	1,302.6	8.91	18	1,114.5	6.15
Wholesale and Retail Trade	1,359	281.8	1.08	64	132.6	.33

Table 1 - Continued

Preliminary 1981 Safe Harbor Lease Information by Business Activity of the Lessee

Business Activity of the Lessee 1/	All Safe Harbor Leases			Safe Harbor Wash Leases		
	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)
Banks & Other Credit Agencies	396	317.8	2.73	123	248.7	1.47
Insurance	256	65.9	.17	14	41.9	.16
Real Estate	165	311.4	3.21	59	274.2	2.62
Brokers & Holding Companies	146	23.0	.15	3	13.2	.15
Leasing	1,037	1,618.7	10.35	199	1,171.5	8.59
Other Services	1,415	193.6	.98	53	49.0	.26
Not Available	2,040	64.7	.10	12	4.9	.10

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.

1/ The lessee is the user of the property. Classification is according to the business activity of the lessee, even if the lessee is a member of a corporate group that is engaged predominately in another activity.

The figures in Table 1 also show that although only 2,120 of the 16,036 leases were wash leases, they accounted for $15.3 billion of leased property, or 80 percent of the total of $19.3 billion. For all leases, fees paid to third parties amount to about one-half of one percent of the value of leased property. This percentage varies considerably by industry, although with no apparent pattern.

Table 2 shows lease data classified by the industry of the lessor. All lessors that are subsidiaries of a common parent corporation are treated as a single lessor in the industry of the parent. The parent's industry classification, in turn, is based on the major activity of its corporate group. The data in Table 2 indicates that the major lessors are in food, chemicals, petroleum refining, nonelectrical and electrical machinery, and leasing. The total number of lease transactions shown is 11,902, of which 1,181 were involved in wash leases.

Table 3 shows lease data by the size of the lease transaction. Most lease transactions are quite small; over 60 percent are for less than $100,000, and nearly 95 percent are for less than $1 million. However, over half of the value of leased property is covered by transactions involving $100 million or more of property, and 85 percent of the value of all property is included in transactions covering $10 million or more of property. Fees paid to third parties, expressed as a percentage of the value of leased property, are about the same for small as for large lease transactions.

Efficiency of Safe Harbor Leasing

The purpose of the safe harbor leasing provisions is to provide to all firms the investment incentives in ACRS and the investment tax credit. Our data indicate how well the leasing provisions have fulfilled this purpose. The present value of the ACRS deductions and the investment tax credit equals about 43.9 cents for every dollar invested. (This figure uses a 15 percent discount rate to value future deductions.) On the average, for all lease transactions, about 6.3 cents of the 43.9 cents of available tax benefits went to lessors. This 6.3 cents is the lessor's net tax benefits in excess of the downpayment made for those benefits. About 0.6 cents went to third parties for transaction fees. The remaining 37.0 cents, or 84.5 percent of the total benefits, were available for lessees. These figures indicate that only 15.5 percent of the investment incentives from ACRS and the investment tax credit were absorbed by lessors and third parties involved in the leasing transaction; the bulk of those incentives (84.5 percent) were made available to the firms actually making the investments.

Table 2

Preliminary 1981 Safe Harbor Lease Information by Business Activity of the Lessor

Business Activity of the Lessor 1/	All Safe Harbor Leases				Safe Harbor Wash Leases			
	Number of Transactions	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)	Number of Transactions	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)
Totals	11,902	16,036	$19,331.9	$108.08	1,181	2,120	$15,432.9	$85.80
Agriculture	71	71	2.2	-	-	-	-	-
Oil and Gas Extraction	3	3	8.4	-	3	3	8.4	-
Construction	46	53	45.8	.04	26	34	18.2	.03
Manufacturing:								
Food & Kindred	44	83	1,440.5	5.93	44	83	1,440.5	5.93
Paper	8	28	148.2	1.92	8	28	148.2	1.92
Printing	42	494	908.7	5.10	24	220	897.0	4.95
Chemicals	102	271	1,100.4	8.91	60	219	1,028.5	7.76
Petroleum Refining	98	235	4,086.7	17.08	84	220	3,349.6	16.62
Primary Metals	13	25	85.9	.93	5	10	81.6	.83
Fabricated Metals	231	242	312.3	1.33	215	224	296.4	1.30
Nonelectrical Machinery	118	280	1,883.4	3.77	33	53	1,784.2	3.08
Electrical & Electronic	1,899	2,173	1,994.3	14.78	22	78	1,497.2	10.94
Motor Vehicles	29	60	462.7	5.66	4	12	294.3	4.99
Other Manufacturing	54	102	1,334.1	2.80	26	68	1,267.9	2.22
Transportation	14	21	271.4	3.61	3	3	251.5	3.54
Communications	21	31	568.2	5.21	21	31	568.2	5.21
Utilities	13	19	96.7	1.24	13	19	96.7	1.24
Wholesale and Retail Trade	723	797	628.8	4.48	174	212	488.3	3.87
Banks & Other Credit Agencies	3,579	5,893	789.7	6.07	90	149	204.5	2.00
Insurance	74	109	457.9	3.22	33	52	380.6	2.60
Real Estate	65	68	97.1	.36	3	6	74.8	.32
Brokers and Holding Companies	796	926	865.5	5.66	78	147	691.5	4.23
Leasing	3,121	3,286	1,209.0	6.13	190	223	159.3	1.62
Other Services	121	124	506.8	4.66	22	25	405.5	1.52
Not Available	615	639	27.1	-	-	-	-	-

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.

1/ The lessor is the buyer of tax benefits. In the case of lessor corporations that are subsidiaries of a common parent, classification is according to the business activity of the common parent.

Table 3

Preliminary 1981 Safe Harbor Lease Information by Value of Property in Lease Transaction

Value of Property in Lease Transaction	All Safe Harbor Leases				Safe Harbor Wash Leases			
	Number of Transactions	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)	Number of Transactions	Number of Leases	Value of Leased Property ($ millions)	Fees Paid to Third Parties ($ millions)
Totals	11,902	16,036	$19,331.9	$108.88	1,181	2,120	$15,432.9	$85.80
Under $100,000	7,544	8,870	224.0	.82	260	267	12.1	.04
$100,000 - $1 million	3,667	5,180	1,033.9	6.37	489	542	182.6	2.17
$1 million - $10 million	445	1,056	1,641.5	14.68	255	513	993.9	7.36
$10 million - $50 million	171	433	3,665.2	26.47	105	305	2,477.1	18.61
$50 million - $100 million	26	200	2,007.4	12.46	26	200	2,007.4	12.46
$100 million or Over	49	297	10,757.9	48.07	45	292	9,759.8	45.15

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.

Tables 4, 5, and 6 show the percentage of total tax benefits going to lessors, third parties, and the percentage available to lessees. The figures are for leases classified by industry of lessee, industry of lessor, and size of lease transaction respectively.

Of the 37.0 cents in present value tax benefits available to the lessee for each dollar of investment, on average 24.9 cents are received as a direct payment from the lessor and 12.1 cents are received in the form of future tax deductions retained by the lessee. In certain cases in which the lessee has had large prior losses, the lessee will be unable to use all of the 12.1 cents in deductions as they become available. Thus, in such cases, the lessee will not be able to make use of the full 37.0 cents of tax benefits. But this fact does not indicate any inefficiency of the lease transaction; it implies that the lessee has large enough prior losses to more than offset the income earned by the investment so that the deductions earned through the lease are not needed. Certainly, for any given lease transaction the measure of inefficiency--the share of benefits absorbed by the lessor and third parties--should not vary with the tax status of the lessee.

The figures given in Tables 4, 5, and 6 on the efficiency of leasing are the most pertinent figures for evaluating how well leasing has achieved the goal of providing the same investment incentives to all investors. It can also be asked what fraction of the revenue loss, as distinct from the total tax benefit, accrues to the lessor, third parties, and the lessee. This fraction is different from those given above because of the difference between the present value of the tax benefits per dollar of investment and the present value of the revenue losses from a lease. The former is the 43.9 cents mentioned above, the latter figure depends on how much of the ACRS deductions and the credit could have been used by the lessee. If the lessee could never have used the credit or the deductions, then the revenue loss from the lease is relatively large. If the lessee could have used the credits or deductions after some delay, then the present value of the revenue loss is smaller.

Our data do not indicate how much of those tax benefits lessees could have used, thus we cannot give a precise figure for the amount of the revenue loss from each lease. If, as an example, lessees could never use any of the ACRS deductions or the tax credit, then our data show that 21.4 percent of the revenue loss from the leases would go to the lessor.

Table 4

Preliminary 1981 Safe Harbor Lease Information by Business Activity of the Lessee, Wash Leases Only

Business Activity of the Lessee	Value of Leased Property ($ millions)	Downpayment ($ millions)	Total Tax Benefits from the Leased Property ($ millions)	Lessors' Net Gains ($ millions)	Ratio of Lessors' Net Gains to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Fees Paid to Third Parties to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Lessees' Benefits to the Total Tax Benefits from the Leased Property (Percent)
Totals	$15,432.9	$3,036.9	$6,775.6	$964.6	14.2%	1.3%	84.5%
Agriculture	37.0	4.9	16.4	3.2	19.5	4.1	76.4
Mining	514.0	130.6	231.2	26.8	11.6	1.5	86.9
Oil and Gas Extraction	710.8	163.5	305.0	43.4	14.2	1.5	84.2
Construction	98.8	20.6	44.5	4.8	10.8	2.1	87.0
Manufacturing:							
Food and Kindred	73.4	16.3	33.0	5.7	17.5	3.1	79.5
Textiles and Apparel	28.1	4.2	12.6	5.4	42.6	-	57.3
Lumber and Paper	1,712.2	513.0	717.8	96.1	13.4	.5	86.1
Printing	1.5	.3	.7	*	6.9	3.3	89.8
Chemicals	1,412.0	363.7	639.6	53.8	8.4	1.0	90.6
Petroleum Refining	425.5	137.5	192.0	36.8	19.2	1.3	79.5
Rubber and Plastics	281.4	68.4	126.8	22.1	17.4	.3	82.3
Stone, Clay, and Glass	573.0	152.1	259.5	40.2	15.5	1.2	83.3
Primary Metals	1,202.8	379.4	605.2	119.8	19.8	.7	79.5
Fabricated Metals	133.2	32.1	62.0	12.8	20.6	.9	78.4
Nonelectrical Machinery	88.5	18.8	39.7	1.1	2.8	.7	96.4
Electrical and Electronics	304.2	73.1	126.8	19.6	15.5	1.3	83.3
Motor Vehicles	1,123.8	200.8	509.5	44.5	8.7	.7	90.6
Other Transportation Equipment	153.8	42.4	72.2	14.2	19.6	1.5	78.8
Other Manufacturing	42.9	7.9	19.4	.6	3.3	.7	96.0
Railroads	1,673.2	432.2	749.6	133.7	17.8	2.2	80.0
Other Motor Transportation	47.3	7.1	17.2	3.3	19.5	4.0	76.5
Water Transportation	143.1	42.1	64.2	10.3	16.0	.8	83.2
Airlines	1,138.3	292.9	508.3	91.8	18.1	1.5	80.5
Other Transportation	35.7	12.2	16.0	1.8	11.0	.9	88.2
Communications	348.0	77.7	155.0	17.2	11.1	1.6	87.3
Utilities	1,114.5	258.0	378.8	68.1	18.0	1.6	80.4
Wholesale and Retail Trade	132.6	30.3	59.5	9.6	16.2	.6	83.3
Banks and Other Credit Agencies	248.7	45.5	112.1	12.1	10.8	1.3	87.9
Insurance	41.9	9.2	18.8	2.1	11.0	.9	88.2
Real Estate	274.2	75.8	123.0	9.9	9.9	2.1	88.0
Brokers and Holding Companies	13.2	2.2	5.9	.1	.9	2.5	96.7
Leasing	1,171.5	204.4	529.1	49.2	9.3	1.6	89.1
Other Services	49.0	9.0	22.0	1.3	5.9	1.2	92.9
Not Available	4.9	.6	2.2	.7	30.0	4.4	65.6

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.
* Less than $50,000.

Table 5

Preliminary 1981 Safe Harbor Lease Information by Business Activity of the Lessor, Wash Leases Only

Business Activity of the Lessor	Value of Leased Property ($ millions)	Downpayment ($ millions)	Total Tax Benefits from the Leased Property ($ millions)	Lessors' Net Gains ($ millions)	Ratio of Lessors' Net Gains to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Fees Paid to Third Parties to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Lessees' Benefits to the Total Tax Benefits from the Leased Property (Percent)
Totals	$15,432.9	$3,836.9	$6,775.6	$964.6	14.2%	1.3%	84.5%
Oil and Gas Extraction	8.4	1.5	3.7	.2	4.4	-	95.6
Construction	18.2	2.3	8.2	.8	9.3	.3	90.4
Manufacturing:							
Food and Kindred	1,440.5	435.2	674.0	126.3	18.7	.9	80.4
Paper	148.2	27.6	66.5	.3	.4	2.9	96.7
Printing	897.0	264.0	404.6	41.2	10.2	1.2	88.6
Chemicals	1,028.5	269.9	446.5	55.6	12.5	1.7	85.8
Petroleum Refining	3,349.6	842.0	1,405.8	127.6	9.1	1.2	89.7
Primary Metals	81.6	22.8	36.6	6.1	16.6	2.3	81.1
Fabricated Metals	296.4	59.7	134.4	19.0	14.1	1.0	84.9
Nonelectrical Machinery	1,784.2	354.9	808.0	58.1	7.2	.4	92.4
Electrical and Electronics	1,497.2	346.0	617.5	168.9	27.3	1.8	70.9
Motor Vehicles	294.3	78.1	132.0	27.8	21.0	3.8	75.2
Other Manufacturing	1,267.9	394.6	555.4	85.9	15.5	.4	84.1
Transportation	251.5	46.0	112.9	26.1	23.1	3.1	73.8
Communications	568.2	149.0	255.0	57.4	22.5	2.0	75.4
Utilities	96.7	22.9	43.5	4.7	10.9	2.9	86.3
Wholesale and Retail Trade	488.3	120.7	220.7	47.3	21.4	1.3	77.3
Banks and Other Credit Agencies	204.5	49.0	91.5	7.5	8.2	2.2	89.6
Insurance	380.6	94.4	171.0	24.1	14.1	1.6	84.3
Real Estate	74.8	12.4	33.9	2.6	7.8	1.0	91.3
Brokers and Holding Companies	691.5	164.2	312.9	48.6	15.5	1.4	83.1
Leasing	159.3	29.6	71.5	5.5	7.7	2.3	90.0
Other Services	405.5	50.0	169.4	23.1	13.6	.9	85.5

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.

Table 6

Preliminary 1981 Safe Harbor Lease Information by Value of Property in Lease Agreement, Only Transactions Involving Wash Leases

Value of Property in Lease Transaction	Value of Leased Property ($ millions	Downpayment ($ millions)	Total Tax Benefits from the Leased Property ($ millions)	Lessors' Net Gains ($ millions)	Ratio of Lessors' Net Gains to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Fees Paid to Third Parties to the Total Tax Benefits from the Leased Property (Percent)	Ratio of Lessees' Benefits to the Total Tax Benefits from the Leased Property (Percent)
Totals	$15,432.9	$3,836.9	$6,775.6	$964.6	14.2%	1.3%	84.5%
Under $100,000	12.1	1.8	5.4	.6	11.7	.7	87.6
$100,000 - $1 million	182.6	28.8	82.0	9.0	11.0	2.7	86.4
$1 million - $10 million	993.9	202.2	447.9	63.4	14.2	1.6	84.2
$10 million - $50 million	2,477.1	612.3	1,106.1	138.9	12.6	1.7	85.8
$50 million - $100 million	2,007.4	521.1	868.1	120.0	13.8	1.4	84.7
$100 million or Over	9,759.8	2,470.7	4,266.2	632.6	14.8	1.1	84.1

Office of the Secretary of the Treasury
Office of Tax Analysis

Note: All figures are preliminary estimates based on a sample of safe harbor lease information returns. Detail may not add to totals due to rounding.

Revenue Effect of Safe Harbor Leasing

As mentioned above, our data do not indicate the revenue loss from each lease. Even if we did know that revenue loss, we would still not be able to calculate exactly the revenue loss from the safe harbor leasing provision, since much of the property in our data probably would have been leased without the safe harbor leasing provision. Much of the revenue loss from these leases would, therefore, have occurred even without the new leasing provision. Thus, these data cannot be used directly to check our revenue estimates. The data on the total volume of leasing are, however, consistent with the volumes we assumed in making the revenue estimates.

The revenue effect of safe harbor leasing, as compared to prior law, is shown below.

Fiscal Year					
1981	1982	1983	1984	1985	1986
($ billions)					
*	-3.2	-3.8	-5.4	-7.3	-9.4

* Less than $50 million.

Form **6793**
(December 1981)
Department of the Treasury
Internal Revenue Service

Safe Harbor Lease Information Return

(Under section 168(f)(8) of the Internal Revenue Code)
For Paperwork Reduction Act Notice, see Instructions.

OMB No. 1545-0843
Expires 1-31-83

Part I For Lessor and Lessee

1a Lessor's name	**1b** Lessee's name
2a Lessor's address (number and street) City or town, State, and ZIP code	**2b** Lessee's address (number and street) City or town, State, and ZIP code
3a Lessor's employer identification number ▶	**3b** Lessee's taxpayer identifying number ▶
3c Lessor's principal business activity and principal product or service (see instructions)	**3d** Lessee's principal business activity and principal product or service (see instructions)
4a Service center where lessor files income tax return	**4b** Service center where lessee files income tax return
5a Does lessor belong to an affiliated group that files a consolidated return? . . . . ☐ Yes ☐ No	**5b** Does lessee belong to an affiliated group that files a consolidated return? . . . . ☐ Yes ☐ No
5c If "Yes" to 5a, enter parent corporation's name, address, employer identification number, principal business activity, and principal product or service	**5d** If "Yes" to 5b, enter parent corporation's name, address, employer identification number, principal business activity, and principal product or service

6 Property Identification

Property	(i) Brief description (see instructions and group properties by ADR midpoint class life)	(ii) ADR midpoint class life (see inst.)	(iii) Recovery class (see instructions and check applicable column for each property) 3 year	5 year	10 year	15 year real property	15 year public util. property	(iv) Date placed in service (mo., day, year)
A								
B								
C								
D								
E								

7 Date lease term began (month, day, year) ▶

8 Length of lease term, in months and fractions of a month:

a Not including any options to extend ______ b Including any options to extend ______

9a Estimated average of lessee's yearly rental payments, for tax purposes, for leases covered by this form . . .

b If rental payments vary according to a formula, give formula by which they are computed ▶

	Yes	No
10a Is the arrangement a sale-leaseback?		

b If "Yes," enter lessor's payment to lessee when lease was made (cash amount or value of other consideration). Exclude lessor's debt to lessee or persons related to lessee . . . .

11 Lessor's debt for the property to lessee or persons related to lessee:

a Term of debt, in months and fractions of a month ▶

b Principal ______ c Annual interest rate ______%

d Total interest payment over term of the debt . . . .

e Method of amortizing principal: ☐ Level-payment mortgage ☐ Straight-line amortization ☐ Other (specify) ______

12 Total paid to third parties to arrange lease (see instructions) . . . .

	Yes	No
13a Has lessee an option to buy the property at end of lease?		
b Can lessor require lessee to buy the property at end of lease?		
c Is there a fixed contract of purchase binding on both the lessor and lessee?		

d If "Yes" to a, b, or c, enter purchase or sale price . . . .
If amount is not specified, give formula by which it is computed ▶

e If "No" to a, b, and c, which party will own the property for tax purposes at end of lease? ☐ Lessor ☐ Lessee

	Yes	No
14a Had lessee made an election under section 46(d) regarding qualified progress expenditures for the leased property?		

b If "Yes," how much investment credit was allowable? . . . .

Signature (See instructions):

Lessor's signature ______ Title ______ Date ______

Lessee's signature ______ Title ______ Date ______

For leases made before January 1, 1982, only.—If lessor and lessee do not file original Form 6793 jointly, indicate filer: ☐ Lessor ☐ Lessee

Part II For Lessor

	Property (refer to line 6)									
	A		B		C		D		E	
15a Lessor's unadjusted basis in the leased property (see instructions)										
b Tentative regular investment credit lessor will claim on property										
c Tentative business energy investment credit lessor will claim on property										
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
d Is there (or will there be) an election made under section 48(d) for the lessee to claim the investment tax credit?										

16 Lessor's debt for the property to others than lessee or persons related to lessee:

a Term of debt, in months and fractions of a month

b Principal

c Annual interest rate %

If rate is not specified, give formula by which it is computed ▶

d Total interest payment over term of the debt

e Method of amortizing principal: ☐ Level-payment mortgage ☐ Straight-line amortization ☐ Other (specify) ▶

17a Is lessor a partnership or grantor trust? ☐ Yes ☐ No

b If "Yes," complete the following information for each partner or beneficiary:

Name

Address

Employer identification number

Service center where income tax return is filed

Principal business activity code and principal product or service

Percentage of ownership or beneficial interest in partnership or trust on date lease was made

Does the partner or beneficiary belong to an affiliated group that files a consolidated return? ☐ Yes ☐ No

If "Yes," complete the following information for the common parent corporation:

Name

Address

Employer identification number

Service center where income tax return is filed

Principal business activity code and principal product or service

Name

Address

Employer identification number

Service center where income tax return is filed

Principal business activity code and principal product or service

Percentage of ownership or beneficial interest in partnership or trust on date lease was made

Does the partner or beneficiary belong to an affiliated group that files a consolidated return? ☐ Yes ☐ No

If "Yes," complete the following information for the common parent corporation:

Name

Address

Employer identification number

Service center where income tax return is filed

Principal business activity code and principal product or service

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Department of the Treasury
Internal Revenue Service

Instructions for Form 6793

(December 1981)

Safe Harbor Lease Information Return

(Under section 168(f)(8) of the Internal Revenue Code)

(Section references are to the Internal Revenue Code.)

General Instructions

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to determine whether your lease arrangement meets the legal requirements for the safe harbor lease election under section 168(f)(8). If you want to make the election, you must give us this information.

Purpose.—Form 6793 is an information return about certain arrangements characterized as leases for Federal income tax purposes. The return must be filed for the lease election to be valid.

Filing Form 6793 late or not attaching a copy to the lessor's income tax return will disqualify the election. A lessor or lessee who has reasonable cause for filing the original Form 6793 within a reasonable period after the deadline is considered to have filed it on time.

If you need more information than these instructions give, see section 168(f)(8) and the related regulations.

Filing Form 6793.—Generally, a separate Form 6793 must be filed for each lease. However, one form may cover multiple leases if:

(1) the same lessor and lessee make the leases;

(2) all the leases have the same beginning date and length; and

(3) the same term of the debt and interest rate apply to all properties covered by all the leases, if the lessor has debt with respect to the properties.

If the lease was made before January 1, 1982, an original Form 6793 must be signed and filed by the lessor, the lessee, or both of them jointly. For leases made after 1981, both the lessor and lessee must sign the original and file it jointly. If the lessor or lessee belongs to an affiliated group that joins in filing a consolidated return, the common parent corporation must sign and file Form 6793 on the subsidiary's behalf.

File the original Form 6793 with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention Form 6793. It must be filed by the later of:

- January 31, 1982; or
- 30 days after the lease is made.

In addition, both the lessor and the lessee must attach a copy of the original form to their income tax returns for the tax year in which the lease begins. For a lessor partnership or trust, a copy of the original Form 6793 must be attached to each partner's or beneficiary's income tax return. (See Specific Instructions for Parts I and II.)

Specific Instructions

If you need more space for any item, attach extra sheets the same size as Form 6793. Show both the lessor's and the lessee's name and identifying number on each sheet, and follow the format on this form. If an item does not apply, enter "N/A."

Parts I and II.—On the original Form 6793 and on the copy filed with the lessor's income tax return, Parts I and II must be completed. Only a copy of Part I, however, needs to be filed with the lessee's income tax return.

Line 3b.—Individual lessees should enter their social security number. All others should enter their employer identification number.

Lines 3c and d.—Trusts that file Form 1041, and individuals, enter the main business activity and product that would be entered on Schedule C (Form 1040). All others enter the principal business activity code and principal product or service that would be entered on their income tax return.

Line 6, col (i).—Give brief descriptions only, and group the properties by ADR midpoint class life.

Line 6, col. (ii).—Enter the property's midpoint class life under the asset depreciation range (ADR), as of January 1, 1981 (without regard to section 167(m)(4)). For ADR class lives, see Rev. Proc. 77–10, 1977–1 C.B. 548, and later revisions.

Line 6, col. (iii).—The property is assigned to one of the following recovery classes. ("Present class life" is defined in section 168(g)(2).)

3-year property is section 1245 property that: has a present class life of 4 years or less; is used in connection with research and experimentation; or is a qualifying horse.

5-year property is section 1245 property that is not assigned to one of the other recovery classes.

10-year property is section 1250 property that has a present class life of 12.5 years or less; public utility property (except section 1250 property or 3-year property) that has a present class life of more than 18 years and no more than 25 years; railroad tank cars; manufactured homes; or certain qualified coal utilization property (Section 168(h)(4).).

15-year real property is section 1250 property that does not have a present class life of 12.5 years or less.

15-year public utility property is public utility property (except section 1250 property or 3-year property) that has a present class life of more than 25 years.

Line 6, col. (iv).—Property is placed in service when it is ready and available for a specific use. Property that is part of a larger facility under one lease is not placed in service until the whole facility is placed in service. If property was placed in service at various dates, enter the range of dates: for example, 6/1/81—7/31/81.

Line 12.—This item applies only if either the lessor or lessee expects the adjusted basis of the property covered by all safe harbor leases it makes during the calendar year to total more than 1 million dollars. If item 12 applies, enter the sum of the lessor's and the lessee's payments to third parties for arranging this lease. Examples of payments to include are brokerage, legal, and investment banking fees.

Line 13.—If an option to buy or sell the property can be exercised before the lease ends, attach a statement specifying when the option can be exercised during the lease and what the purchase or sale price is. If the price is not fixed, give the formula by which it is computed.

Signature.—Original signatures are required on the original Form 6793, but copies are acceptable on the forms filed with the income tax returns. For leases made before January 1, 1982, the lessor, the lessee, or both must sign Form 6793. If the lease is made after 1981, both the lessor and lessee must sign. The common parent corporation must sign on a subsidiary's behalf. For a corporation, Form 6793 must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other corporate officer (such as tax officer) authorized to sign.

Line 15a.—The unadjusted basis means the part of the basis that the taxpayer does not amortize or elect to treat as an expense under section 179.

The basis is determined under part II of subchapter O of chapter 1, without the adjustments described in section 1016(a)(2) and (3). Amortization includes the deduction allowed under section 167(k).

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THE
JOHN DEERE
LEASE PLAN

NEW PLAN LETS YOU NAIL DOWN THE PRICE OF THE PURCHASE OPTION IN ADVANCE

The John Deere Lease Plan now provides a purchase option on 5-year leases that gives you a guaranteed right to buy the leased equipment at the end of the lease term. This new provision also makes it possible to set the end-of-lease purchase price before you sign the lease agreement. If you've leased farm equipment before—or if you've thought about leasing but put it off—you should take a close look at the new 5-year lease offered by John Deere. Leasing may truly be the best way for you to get the tractor, combine or other equipment you need. Ask your dealer for all the details.

John Deere JDFP Finance Plans

We can help your dollars do more

THE
"SAFE HARBOR"
LEASE/OWNERSHIP PLAN

THE "SAFE HARBOR" PLAN

Equipment Value	$50,000.00
Down Payment	—
Amount Financed	50,000.00
Annual Payment	11,971.00
Total Payments	59,855.00
Purchase Option	1.00
Total Cost to Own	59,856.00

Savings Over "LOW RATE" $ 8,258.00

VS.

13.9% "LOW RATE" RETAIL PLAN

Equipment Value	$50,000.00
Down Payment	10,000.00
Amount Financed	40,000.00
Annual Payment	11,623.00
Total Payments (5 yr.)	58,114.00
Purchase Option	—
Total Cost to Own	68,114.00

The benefits of leasing. Plus ownership.

A "Safe Harbor" lease/ownership plan is like a low-cost retail sale with the tax advantages of leasing. Looked at another way, it's like a regular lease except that at the end of the lease period you have the option to buy—on very attractive terms. Just pay $1.00 (One Dollar) more and the machine is yours. Your total cost of ownership is guaranteed from the beginning.

"Compound your savings" at tax time.

For Federal Income Tax purposes, your "Safe Harbor" lease/ownership plan is definitely a lease. That means you can deduct not just finance charges, but the full amount of all lease payments. You save two ways. First, on the remarkably low rates themselves, and then again at tax time. But, unlike the usual leasing situation, you can look forward to reaching "Safe Harbor"—ownership—and taking title to your equipment.

No better time, no better line.

There's never been a better time to put Allis-Chalmers equipment to work on your farm. And there's never been a better line of farm equipment than today's innovative new Allis-Chalmers tractors, conventional and rotary combines, conventional and conservation tillage tools and precision planters. All better by design and proven by experience.

And available now at the lowest rates ever.

9.9% 5-YEAR FINANCING.

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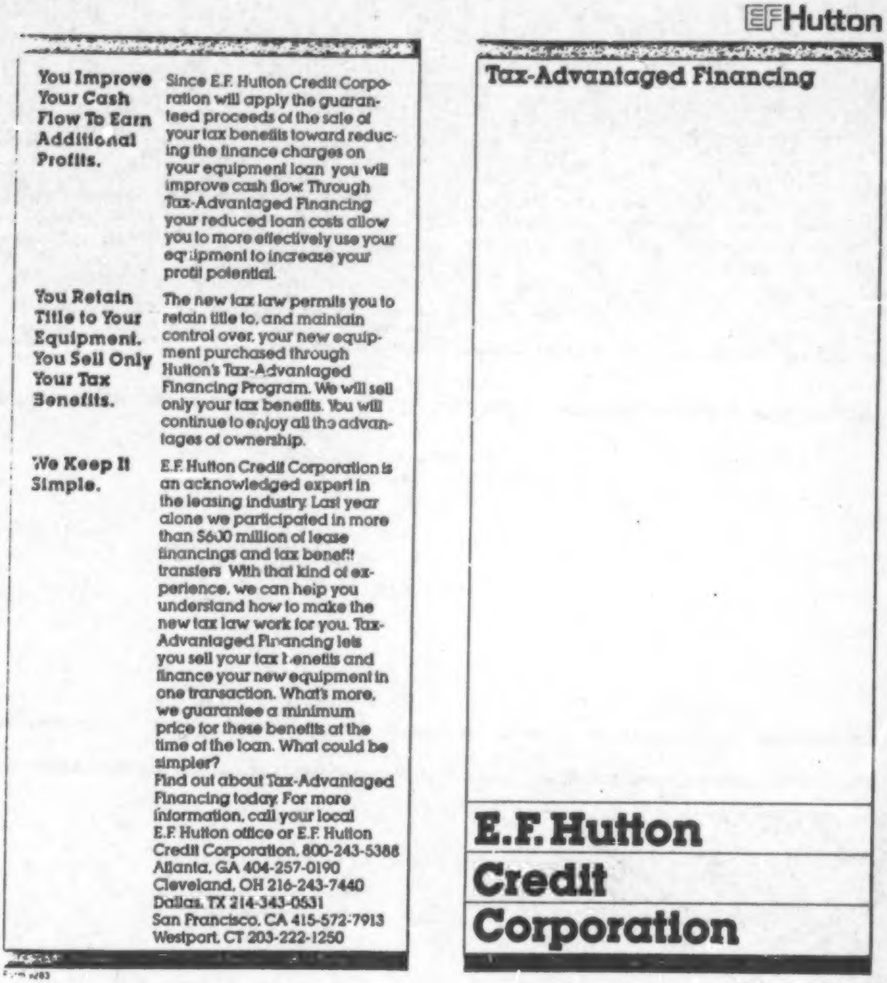

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Senator D'AMATO. Mr. Janeway of Janeway Publishing is next.

STATEMENT OF ELIOT JANEWAY, PRESIDENT, JANEWAY PUBLISHING RESEARCH CORP., NEW YORK, N.Y.

Mr. JANEWAY. Mr. Chairman, Senator Nunn, I appear before you and your colleagues this morning with a high sense of responsibility. To the best of my knowledge, it was the testimony I submitted to this committee on March 9 which launched into the opinion stream the idea of a new entitlement program calculated to save the Treasury money, not to cost it more money.

Specifically, I advocated entitlements for smaller businesses—entailing no new Treasury disbursements—to use their tax losses as last ditch alternatives to insolvency, or bankruptcy, by swapping them with profit corporations able to use them.

My approach called for monetizing tax losses in a free, private market as a defensive strategy calculated to protect the economy and the Treasury against the danger I foresaw of bankruptcy splintering the base of the economy.

I find myself obligated therefore, to express a sense of keen dismay over the legislative legerdemain which transformed my simple suggestion into the complicated, costly, and inequitable device known as safe harbor leasing.

The Treasury is defending the safe harbor clause written into the 1981 tax bill as the most equitable application of the accelerated depreciation incentives given to businesses investing in new plant and equipment. But glaring inequities are built into the ability to enjoy access to the safe harbor mechanism. High-powered batteries of expensive lawyers and accountants are indispensable for entry. Megabucks of ready cash are the engine of discrimination inside safe harbor dealings.

Under present conditions, the Treasury's case for standing pat excludes every independent small business in sight, if not by law, then by effect. This is a raw deal from a stacked deck. Yet the Treasury is defending it on grounds of equity.

Luckily for all of us, what is fair will also work—fast! Many years ago, Congress legislated the Small Business Administration into existence. The present emergency suggests an economic function for the SBA to fill at no cost to the Treasury, and with no need of violating the administration's budget austerity guidelines.

Pioneering ventures are making a go of the barter business by serving as a clearinghouse, the private equivalent of the yellow pages for private swappers of anything from loaded coal cars for airplanes to bicycles for restaurant meals. The barter business charges a cash fee for the service. The SBA could, too.

The simple expedient of authorizing the SBA to act as a clearinghouse between loss corporations and profit corporations would buy time for loss corporations and, with it, the endangered species on their payrolls.

No cost or burden to the Government would result from entitling smaller loss corporations to engage in the free market bartering of their tax losses with profit corporations, large and small. Any profit business filing its tax return would merely append the tax returns of the loss corporations whose losses it had bought, claiming those losses as its deductions, and stating what consideration it had paid for the privilege.

I am the last to argue against depreciation or other incentives when they have an outside chance of making the difference between business decisions to go forward with investment projects or to hold back. But, what small business is in a position to invest today?

So long as profit corporations having the money to accept the incentive invitations offered by the 1981 tax bill are holding back everyday expenditures and laying people off, it is scarcely realistic to expect small loss corporations or, for that matter, even smaller businesses in the black, to find the money to freeze in investment.

When holding back is the rule of the road, as it clearly is today, the hard evidence of inequity is compounded by the hard evidence of inefficiency. I am against the insider dealing invited by the safe harbor clause. We do need tax incentives, but surely when everyone has profits. What we need right now, however, is to use losses to buy time to keep smaller businesses and everyone connected with them going.

I am for free trade in tax loss swaps. I am for turning the tax loss swap concept into a private economic asset and a public economic benefit.

I hope that the evidence accumulating will not provoke congressional action to throw the baby out with the bathwater. That is to say, I earnestly hope that Congress will distinguish between the tax loss swap concept and the machinery leasing distortion to which it has been subjected.

In that case, I hope that Congress will make another try at adapting the swap principle for a use that will be practical as well as equitable under present and future circumstances.

Everyone agrees that the first urgent order of the day is to mobilize the resources of the private sector to help people keep the jobs they still have. The only hope of doing this is to stanch the hemorrhage of bankruptcies.

Mr. Chairman, bankruptcy is a luxury. Casualties of the storm need to be able to find the cash to cover the costs of court protection; for every small business counted among the legally bankrupt, many more simply slip away into the shadows. Some settle privately for a few cents on the dollar with favored creditors, still others vanish and fewer than ever before go under with any resolve, much less the wherewithal, to take another entrepreneurial plunge.

The current trauma of bankruptcy has dramatized the need to renew the will to come back. I suggest that this committee focus its scrutiny on turning the quest for incentives not needed during a slump into the incentive desperately needed in this slump to come back after going broke, or, better still, to keep going after a near miss.

The spectacle of unemployment and bankruptcy feeding on one another points to a third urgency. To stop the run on the Treasury. Its deficit is gunning interest rates and, therefore, inflating costs without providing any offsetting benefits in employment and, therefore, in tax collections.

Smaller businesses are well known to provide more jobs than the Fortune 500 or even the Fortune 1000. By the same token, employed individuals pay out a steadier cash flow to the Treasury than profit corporations accruing tax obligations after availing themselves of their tax preference options to borrow, to spend, and to invest.

If there is any single way guaranteed to keep the budget deficit in 12 digit territory—that is $100 billion plus—it is to allow smaller businesses to continue to go under and to take their employees with them. Bankruptcies breed unemployment, and unemployment returns the compliment.

By the same token, incentives calculated to keep employers going, keep their employees going, too. That is the bottom line test for the Treasury. Tax loss incentives that keep payroll dollars flowing out of smaller businesses, especially smaller loss businesses, earn their keep with the Treasury by bringing withholding dollars back into it.

A final consideration aimed at the equities, as well as the practicalities, of this grim situation. The Tax Code obligates employers to withhold income tax from the payroll dollars they disburse on payday for deposit into custodial accounts at commercial banks of their choice after 3 working days.

This means that embattled employers are in effect financing banks that are already well financed. Marginal employers are watching banks, which collect withholdings that are painful for them to pay, collect interest on the same withholdings, and then cancel their lines of credit. Borrowers and lenders alike are victims of this sorry situation.

I suggest that this committee give consideration to the equity and the efficiency of entitlements to small businesses to use their withholding payments—with the knowledge and approval of affected employees—during any previous quarter to qualify them for bank credit secured by prospective refunds from the Treasury during the next reporting quarter.

This device could not be more simple. The thrust of the proposal is to accelerate refunds in time to keep failing businesses going; that is to say, to use distress disbursements to minimize the distress before the workforce is scattered instead of afterwards.

Banks are not likely to withhold credit from loss businesses building up refund entitlements from the Treasury during a period of general distress. It is axiomatic that failing businesses need credit. Refund entitlements would also entitle loss businesses to bank accomodation.

Emergency injections through the withholding and refund mechanism would help the private sector build defenses against the further economic collapse that is a clear and present danger.

You will want to know that I have discussed this last proposal with Chairman Jones of the House Budget Committee and that he appears to be inclined to give it careful consideration.

Thank you.

Senator D'Amato. Thank you, Eliot.

Let me ask you: At this time; with the furor that is developing over the sale of tax losses, do you believe that it would be wise to repeal the leasing provisions as they are enacted at the present time?

Mr. **Janeway**. I gather from the media that the tax writing committees appear to be under pressure and appear to be disposed to repeal them. I sense a feeling of discrimination in response to the 1981 tax bill. Some of the best corporations in the country, the most profitable corporations in the country, are running at severance rates of over 10 percent. These are permanent severance rates. Layoff rates are at 30 or 35 percent. This is before we get hit with cancellations in the strongest sector of the economy, the producers of durables for export to the oil producing countries. Those cancellations are just coming.

In an atmosphere of that sort, with corporations like Caterpillar Tractor announcing these layoffs and severances, I doubt that any controversial incentives will induce them to buy machinery and make capital goods investments.

I think that the urgency of the day is to keep payroll dollars going. When the Caterpillars are in these accelerated layoffs—and it is one of the companies most prominent in producing durable exports—I think that incentives which may be helpful in a period of pick-up, become a misplaced priority, especially if they cost the Treasury either any cash of consequence or any symbolic exemption.

Senator **D'Amato**. Can you envision any scenario where the safe harbor leasing provisions would be good and would be an infusion for the small business community and small businessmen?

Mr. **Janeway**. Yes, I could.

Let us say we are in 1983, confronted with an international emergency. Assume that the Pentagon let 1982 without stepping up expenditures needed to modernize our infrastructure, because it was relying on tax incentives useful in a high profit economy to stablize a loss economy. It is well to remember that during World War II and during the Korean emergency, we shut down automotive and homebuilding. Now we are waiting for them to revive.

Under those circumstances, corporations which had been in trouble—we hope Chrysler and Harvester will still be with us—if they are trying aggressively to rebuild their dealer organizations, if they are bottlenecked in trying to get suppliers back in business, if even the Pentagon is worried about single source procurement, yes, I could see it would have a place.

When we are bottlenecked, when we are looking for sources of outlet and sources of supply, yes, but not under present circumstances when the base of the economy is splintering, when corporations are losing their outlets and losing their suppliers.

Senator **D'Amato**. What do you think would be the effect? I take it then you think it should be repealed, basically?

Mr. **Janeway**. I confess that I am imbued with no enthusiasm for fighting against what I perceive to be the disposition to repeal, but I do not see any need to give it resuscitation.

Senator **D'Amato**. What do you think the effect might be if we repealed safe harbor leasing for large companies but retained it for at least one party in the transaction, lessee or lessor, is a small business?

Mr. **Janeway**. I do not think it would have a material effect, Mr. Chairman, unless and until those smaller businesses felt an incentive to go out and get machinery.

Right now it seems to me the pressure throughout the private sector is in exactly the opposite direction. The corporations which originate leases have enormous leases out. Many of them perhaps were sold with an excess of enthusiasm. They are petrified that those leases are going bad on them with very serious consequences to their earnings.

Also, if outstanding leases go bad, those corporations which are among the most profitable in the economy will be putting in for enormous entitlements to refunds.

Senator D'AMATO. What about the utilization of these leases by ailing corporations such as airlines where there is a need for equipment and there is a tremendous capital cost involved?

Mr. JANEWAY. They have over half their fleets laid up now. There is not any sort of market for used equipment. I do not think that that will help them very much.

We have had what? Four months of it? Six months of it? It does not seem to have provided much activity or very much of a stimulus for new investment.

Senator D'AMATO. Let me leave you with this one last thought. I know you were here when Mr. Chapoton talked. I indicated to him that it seems to me we have done a very poor job in dispelling the perception that safe harbor leasing is a tool of big business. It appears now that it can be utilized only for large and profitable corporations and at the expense of the American taxpayer. That is the perception.

Let us talk about the farmers and their problems.

Mr. JANEWAY. The farmers?

Senator D'AMATO. The farmers.

Mr. JANEWAY. I am ready.

Senator D'AMATO. Can this be used as an effective tool in dealing with the farmers of the United States who have the great problem of trying to go out and get the equipment which is necessary today and which are high cost items, particularly given today's interest rates. Can leasing be used as a tool in purchasing that equipment which is necessary? Would this not give farmers substantial aid?

Mr. JANEWAY. There is an enormous amount of grain that has been withheld from the market. I would assume that all those storage facilities are mortgaged to the hilt and that farmers are borrowing the interest and compounding the interest on that debt.

John Deere, one of those "Caterpiller blue chip" type corporations, is announcing layoffs. Governor Ray of Iowa told me about 6 weeks ago that something like 5,000 skilled working people have immigrated, left, and scattered from the industrial part of Iowa where John Deere is.

I cannot see it providing any investment lift to the farm sector. I think we need loss incentives. I think we need safety nets. I think the emphasis on the part of the Treasury is misplaced. I think we need devices to keep the money flows going.

If we get 8 consecutive weeks in this particular situation of balmy weather with no lift discernible in the economy, and if Treasury borrowing does not come down as we are now hearing it will during tax collection time, we will know we have not been in recession because a recession is self-correcting. I see no evidence of self-correction.

Senator D'AMATO. You would indicate that this goes beyond a recession?

Mr. JANEWAY. Yes, sir.

Senator D'AMATO. Would you care to characterize that feeling?

Mr. JANEWAY. It is some sort of paralysis. It is a slump which has many characteristics of an incipient depression. I am not familiar with any pattern of events in economic history which produced the coincidence of a collapse—that is not my word, but that is the word that many administration advisers are using—in the economy and this stubborn, sustained level of interest rates.

Nor am I aware of any such collapse or slowdown, or whatever you want to call it, in the economy coinciding with a bulge in private sector borrowing. The borrowing clearly is not discretionary borrowing with profit the motive. This is one of my difficulties with safe harbor. The borrowing appears to be necessitous to pay interest, to meet payroll, to pay withholding, to pay dividends. A very disturbingly high portion of present dividend flows, which are important to the Treasury, appear to be financed by short-term borrowing that is rolled over. These borrowings are all short term.

I am not familiar with any coincidence of trillion dollar future year defense obligations and a collapse in current activity. It seems to me if this goes on through the spring with weather no longer the alibi, if the oil producing countries beginning with the Saudis begin to cancel this enormous load on the world economy of machinery commitments from Korea to East Germany, then there will be no second quarter recovery. Yesterday one of the presidents of the major corporations involved in petrochemical work, in this case a sulfur byproduct extraction plant for natural gas, told me that they were ready to ship this system out of New Orleans this week, and yesterday morning they got by telex a notice to mothball.

I am afraid I have been overconservative and overoptimistic. I had thought this would not come until perhaps April of this year. I had thought it would come when spot oil broke $30, which apparently it has done.

I think, Mr. Chairman, you and I share a New York background, although mine is rather senior to yours and is of Brooklyn Bums vintage. I remember that the late great Red Smith wrote a memorable column on one occasion about the Brooklyn Bums when he observed two outfielders looking at each other while a popfly dropped in between them.

Senator D'AMATO. That was often the case.

Mr. JANEWAY. In his prophetic and inspired forecasting, he said he supposed that the next thing that would happen to top this act would occur when these two outfielders have another conversation and one of them will get hit on the head with a popfly.

You asked me how I would characterize this economy. The vision of the Brooklyn Bums comes back unforgettably to my mind as I observe the administration waiting for the economy to make all our worries blow away, while the economy waits for the administration to make all our worries blow away.

Then I hear our good friends the monetarists—I could not be more fond of Professor Friedman and I observe that the President quotes him with awe—saying do not do anything; just stand there.

That is a sure-fire prescription for disaster today. It seems to me that we'd better start doing things beginning with our farmers and the Saudis on the economic front, or we are going to discover too late that this is no recession that began last year.

We have never before had a situation that I am aware of in which a trillion dollar obligational load was laid on the economy as its pie in the sky in the future, while the administration was trying to figure out how to stimulate the economy.

In every previous step-up in future year defense obligational authority, the problem was how to ration the economy and hold it back. Mind you, as I recall emphasizing when I was here in March, on the Monday morning after Pearl Harbor, the Treasury bill rate was 1 percent. On the Monday morning after Korean Sunday, after we had absorbed a virulent wartime inflation registered in a massive increase in interest rates, a 50-percent increase, the Treasury bill rate was 1.5 percent.

Every day the Treasury goes on borrowing its interest and borrowing its refunds—and at these rates—its deficit cascades. This explains my anxiety to see action initiated before the first cycle of refunds triggers a second cycle of benefit and welfare payments, adding to the burdens of the cities and the States.

Senator D'AMATO. I would take it that you disagree then with those recent pronouncements that the deficits have relatively little to do with interest rates being as high as they are?

Mr. JANEWAY. Absolutely. The deficits, powered as they are by the defense budget, have frightened the markets to death without producing any offsetting stimulus to activity as commonsense would expect one to anticipate, and as experience of past emergencies has demonstrated from the outlays flowing from those obligations.

We have landed ourselves in the well-known position, Mr. Chairman, of being in the worst of both worlds.

Senator D'AMATO. I have taken too much time.

Senator Nunn?

Senator NUNN. Thank you very much.

Eliot, I find your testimony informative and intriguing as usual.

Mr. JANEWAY. Thank you.

Senator NUNN. As I understand it, what you are saying is that you feel the present safe harbor rules are inequitable as they pertain particularly to the small business community.

Mr. JANEWAY. Yes, Senator.

In addition, I confess to this. When one hears stories of huge fees, in no way suggesting any sinister practice but simply because complications involve the assembling of batteries of blue ribbon law firms and the accumulation of many, many expensive man-hours of legal and accounting talent, in the present atmosphere, the average entrepreneurial mentality simply turns off.

The fellow who is trying to meet a payroll and worrying about a new product, if he is a Chevrolet dealer, for example, he says, "That surely does not mean me."

Even the newspaper accounts of first deals that were put together were so intricate, were so painstaking, involved so much time that this created an atmosphere of exclusivity, restriction, and elitism.

The Chrysler people, for all of their distress—it was before they sold their tank facility—have always had the Mitsubishi backup. I have never for the life of me understood why neither this administration nor the previous administration invited Mitsubishi to assume responsibility for Chrysler's problems, the national responsibilities. The tank arsenal was going to be sold anyway.

When I was in Tokoyo, Ambassador Mansfield, for whom we all share the greatest respect, spoke to me with the greatest dismay because no one had ever canvassed the idea with him. Chrysler, despite its difficulties, rejected the first safe harbor leasing offer, which Harvester took, on the grounds that their birthright was being taken away, that it was a rough deal exploiting their strength to weakness.

Chrysler has had these two standbys, these fallback strengths, the Mitsubish connection and the tank arsenal. It held its ground and refused to do it. Harvester felt obliged to go along with a safe harbor deal. That suggests that if Chrysler dealt from weakness—I think the record will show that it rejected the offer—that many of these offers are not exactly on equal terms.

I hope that provides the background to my answer to the question of equity and evenhanded bargaining.

Senator NUNN. What you are suggesting is a much simpler scheme of having everyone involved, all corporations as I understand it to be able to sell their losses.

Mr. JANEWAY. Including proprietorships.

Senator NUNN. That would be independent of whether they procured new machinery or new equipment or whether they were a service corporation. It would be a question of if you had a $10,000 loss, you would go through a brokerage outfit and you would sell it to someone who needed it.

Mr. JANEWAY. Go to the SBA.

Senator NUNN. It would be a free market. Is that right?

Mr. JANEWAY. Yes, sir.

When Jesse Jones was Roosevelt's finance chief, he boasted of the fees and interest he earned for the Treasury. There was a great windfall to the Treasury which did not really need it then. We folded up the Federal lending agencies following the Depression and World War II FHA, which in many ways was the soundest and most efficient of all the New Deal innovations, has always been an earner for the Treasury.

I do not see why the SBA, instead of being off on some sort of marginal and even lurid fringe, cannot begin to earn a lot of money for the Treasury. I know I am a very diligent reader of the media. Whenever I see the SBA in a story, I want to know what the dirt is. I think that is unfortunate. I do not see why SBA cannot be in there producing cash like the Export-Import Bank and other such agencies.

Senator NUNN. What would be the essential difference between this kind of proposal and one that would be a refundable tax credit simply from the Treasury? What would be the difference?

Mr. JANEWAY. You keep activity going. I worry about the refund dollar very much, Senator. In this situation where you have so many different types of dollars, the refund dollar is the most irresistable when received by the taxpayer, the most irresistable to turn into molasses.

When you get a refund dollar, you turn it into the slowest velocity dollar in the situation. Right now, it is just hemorrhaging out of the Treasury. A refund dollar incurs no cost of interest. There is no obligation to repay it. There is no incentive to prepay it. You put it out to interest. You use it to extinguish a debt. You need not share it with a partner as if it were a profit. You need not disburse it. You are not allowed to disburse it to shareholders in a dividend.

You will not need to part with that money again until the next time you think the coast is clear and until first you make a discretionary investment, which you think will be a sure thing, to incur another taxable earning after you have gotten back your loss.

These refunds, which are safety nets for people incurring losses, are very, very decelerating, shall we say, to the economy.

Senator **Nunn**. Would you apply this to individuals also, or would it be limited to corporations?

Mr. **Janeway**. I would urgently liberalize. In the same spirit as your initiative on the IRA last year, I would liberalize the allowable offset of the capital loss against earned income.

We have many proprietorships being forced to absorb capital losses making distress sales of machinery. You know you are in a positive, expansive business situation when the secondhand machinery market is in great shape. However, people are dumping in order to get cash. These people, who may be employers in proprietorships, are laying people off because if you run up a $15,000 or $20,000 loss selling a printing press or something like that you cannot use it against your ordinary income. You are allowed just $3,000.

Look at the losses in the stock market. Look at the losses in the bond market. The speculative losses in the commodity markets, too, are not being used. They are really capital levies. If people who cannot use losses, and who have no earnings, are reduced to one method of keeping people on their payrolls, and that is to make necessitous bank loans, a 20-percent interest rate is not a 10-percent interest rate for those people. You need earnings for it to be deductible.

Senator **Nunn**. Mr. Chairman, I know we have two or three panels and we could go into considerably more detail on some of these ideas, but on the refund you talk about allowing small businesses to use by shifting, I assume, the requirement for deposit and when it is deposited. Are these refunds relating to employees? When you mention the payroll, are you talking about employee refunds or are you talking about the refunds of the corporation itself?

Mr. **Janeway**. I am thinking primarily of the payroll refund, but of course in a small business the proprietor or the inside group generally will account for a considerable share of the payroll.

If your choice is between——

Senator **Nunn**. How do you know an employee is going to get a refund if you are the employer? That is the question I have. What triggers the amount of the anticipated refund?

Mr. **Janeway**. My thinking is that if the employee is still an employee, still on the payroll, the payroll is still coming every week, if the employees are informed and consent that their withholding of the previous quarter will be refunded to the company, in which case you really have a form of job security without a contract, then it is the payment withheld from the payroll in the previous quarter that is refunded to the employer. You have done that before the work force has scattered, before the business has been liquidated. I think I am aware of a neck-and-neck race between voluntary liquidation, the decision to pack it in and quit, come out with whatever you can, and bankruptcy.

Many people are afraid of overstaying. Employers making that voluntary decision—not to overstay, but to liquidate—will wind up in 3 to 9 months getting some sort of business refund. But the employees are going to wind up on benefit or on welfare.

People subjected to those decisions last autumn are now exhausting their 6-month entitlement. The thrust of my thinking is to keep the work force intact.

Mind you, one of the purposes of the withholding is social security. In the present atmosphere, if you ask anyone whose job and whose livelihood and whose obligations are on the line what is their priority, would they want next week's paycheck or would they want a contribution of their future year's social security, you will get a very quick answer to a very simple problem. You get 105 percent votes to keep the job going, to keep the payroll going.

If you go to your bank, which is your depository, and you use this entitlement, and you say, "In the last quarter I paid *x* dollars in withholding on behalf of my employees of whom I am one," the bank is not going to cut you off.

Mr. Chairman, we saw the J. W. Mays bankruptcy in New York. That was a substantial department store serving low-income clientele. A major bank—I have no idea whether it was their withholding depository—cut them off on Thursday. On Friday they were in chapter 11.

I am deliberately waiving my own premise that the second quarter is going to be weaker than the first. I always like to assume that I am going to be wrong. If I am wrong, if those who are predicting or banking on a second quarter pickup are right, then all the more reason not to let more of the work force get scattered before June.

If there were to be a miraculous automotive pickup, I do not know what you would do. You asked me a question in this connection before, Mr. Chairman. I do not know what you would do about reassembling the automotive work force. You will not find them in the California relief rolls.

Now I hear that Texas is going soft. I am speaking of the strongest sectors of the economy. You had none stronger than oil and gas drilling. That uses a lot of work when it gets down to 15,000 feet where it has been.

That is all soft and going bad in the last month. You have had this migration from the frost belt, from the automotive economy, into the oil and gas economy. That is now over.

The economy demonstrated enormous vigor and resilience in the first half. You and I have discussed this. Despite its weakest links—automotive and homebuilding—going bad, this was so.

One reason it did was that the strongest sectors remained strong. However, if now the two strongest sectors, producer durables for export, especially to the oil producing countries, and oil and gas domestically, go bad, the second shoe will drop on the weakest links.

My concern is to keep as much of the work force assembled as possible. The Treasury has that incentive because that is where the withholding dollars come from.

Senator NUNN. Thank you very much, Eliot.

Thank you, Mr. Chairman.

Senator D'AMATO. Eliot, I would like to thank you for your very thought-provoking testimony today.

Mr. JANEWAY. It is my privilege, Mr. Chairman. As New Yorkers, we have to stick together.

[The prepared statement of Mr. Janeway follows:]

PREPARED STATEMENT BY ELIOT JANEWAY

Mr. Chairman, I appear here before you and your colleagues this morning with a high sense of responsibility. To the best of my knowledge, it was the testimony I submitted to this Committee on March 9 which launched into the opinion stream the idea of a new entitlement program calculated to save the Treasury money; not to cost it more money. Specifically, I advocated entitlements for smaller businesses to use their tax losses as last ditch alternatives to insolvency, or bankruptcy, by swapping them with profit corporations able to use them. My approach called for monetizing tax losses in a free private market as a defensive strategy calculated to protect the economy and the Treasury against the danger I foresaw of bankruptcies splintering the base of the economy. I find myself obligated, therefore, to express a sense of keen dismay over the legislative legerdemain which transformed my simple suggestion into the complicated, costly and inequitable device known as 'safe harbor" leasing.

The Treasury is defending the safe harbor clause written into the 1981 Tax Bill as the most equitable application of the accelerated depreciation incentives given to businesses investing in new plant and equipment. But glaring inequities are built into the ability to enjoy access to the safe harbor mechanism. High-powered batteries of expensive lawyers and accountants are indispensible for entry. Megabucks of ready cash are the engine of discrimination inside safe harbor dealings. Under present conditions, the Treasury's case for standing pat excludes every small business in sight -- if not by law, then by effect. This is a raw deal from a stacked deck, yet the Treasury is defending it on the grounds of equity.

Luckily for all of us, what is fair will also work -- fast! Many years ago, Congress legislated the Small Business Administration into existence. The present emergency suggests an economic function for the SBA to fill at no cost to the Treasury, and with no need of violating the Administration's budget austerity guidelines. Pioneering ventures are making a go of the barter business by serving as a clearing house, the private equivalent of the yellow pages for private swappers of anything from loaded coal cars for airplanes to bicycles for restaurant meals. The simple expedient of authorizing the SBA to act as a clearing house between loss corporations and profit corporations would buy time for loss corporations and, with it, the endangered species on their payrolls. No cost or burden to the government would result from entitling smaller loss corporations to engage in the free market bartering of their tax losses with profit corporations, large and small. Any profit business filing its tax return would merely append the tax returns of the loss corporations whose losses it had bought, claiming those losses as its deductions, and stating what consideration it had paid for the privilege.

I am the last to argue against depreciation or other incentives when they have an outside chance of making the difference between business decisions to go forward with investment projects or to hold back. But what small business is in a position to invest today? So long as profit corporations having the money to accept the incentive invitations offered by the 1981 Tax Bill are holding back everyday operating expenditures, it is scarcely realistic to expect small loss corporations or, for that matter, even smaller businesses in the black, to find the money to freeze in investment. When holding back is the rule of the road, as it clearly is today, the hard evidence of inequity is compounded by the hard evidence of inefficiency. I am against the insider dealing invited by the "safe harbor" clause. We need tax incentives, but when everyone has profits. What we need right now, however, is to use losses to buy time to keep smaller businesses and everyone connected with them going. I am for free trade in tax loss swaps. I am for turning the tax loss swap concept into a private economic asset and a public economic benefit.

I hope that the evidence accumulating will not provoke Congressional action to throw the baby out with the bath water; that is to say, I earnestly hope that Congress will distinguish between the "tax loss swap" concept and the machinery leasing distortion to which it has been subjected. In that case, I hope that Congress will make another try at adopting the swap principle for a use that will be practical as well as equitable under present and future circumstances.

Everyone agrees that the first urgent order of the day is to mobilize the resources of the private sector to help people keep the jobs they still have. The only hope of doing this is to stanch the hemorrhage of bankruptcies. Mr. Chairman, bankruptcy is a luxury. Casualties of the storm need to be able to find the cash to cover the costs of court protection; for every small business counted among the legally bankrupt, many more simply slip away into the shadows. Some settle privately for a few cents on the dollar with favored creditors, still others just vanish and fewer than ever before go under with any resolve, much less the wherewithal, to take another entrepreneurial plunge. The current trauma of bankruptcy has dramatized the need to renew the will to come back. I suggest that this Committee focus its scrutiny on turning the quest for incentives not needed during a slump into the incentive desperately needed in this slump to come back after going broke, or, better still, to keep going after a near miss.

The spectacle of unemployment and bankruptcy feeding on one another points to a third urgency: to stop the run on the Treasury. Its deficit is gunning interest rates and, therefore, inflating costs without providing any offsetting benefits in employment and, therefore, in tax collections.

Smaller businesses are well known to provide more jobs than the Fortune 500, or even the Fortune 1000. By the same token, employed individuals pay out a steadier cash flow to the Treasury than profit corporations accruing tax obligations after availing themselves of their tax preference options to borrow, to spend and to invest. If there's any single way guaranteed to keep the budget deficit in twelve digit territory, it is to allow smaller businesses to continue to go under and to take their employees with them. Bankruptcies breed unemployment, and unemployment returns the compliment. By the same token, incentives calculated to keep employers going, keep their employees going, too. That's the bottom line test for the Treasury. Tax loss incentives that keep payroll dollars flowing out of smaller businesses, especially smaller loss businesses, earn their keep with the Treasury by bringing withholding dollars back into it.

A final consideration aimed at the equities, as well as the practicalities, of this grim situation. The tax code obligates employers to withhold income tax from the payroll dollars they disburse on payday for deposit into custodial accounts at commercial banks of their choice after three working days. This means that embattled employers are in effect financing banks that are already well financed. Marginal employers are watching banks, which collect withholdings that are painful for them to pay, collect interest on the same withholdings and then cancel their lines of credit. Borrowers and lenders alike are victims of this sorry situation.

I suggest that this Committee give consideration to the equity and the efficiency of entitlements to small businesses to use their withholding payments during any previous quarter to qualify them for bank credit secured by prospective refunds from the Treasury during the next reporting quarter. This device could not be more simple. The thrust of the proposal is to accelerate refunds in time to keep failing businesses going; that is to say, to use distress disbursements to minimize the distress before the workforce is scattered instead of after. Banks are not likely to withhold credit from loss businesses building up refund entitlements from the Treasury during a period of general distress. It's axiomatic that failing businesses need credit. Refund entitlements would also entitle loss businesses to bank accomodation.

Emergency injections through the withholding and refund mechanism would help the private sector build defenses against the further economic collapse that is a clear and present danger.

Senator D'AMATO. We call our next panel: Mr. W. H. Griffin, Griffin Lumber Co., Georgia; Mr. Harold Edwards; and Mr. Owen Willaman, president, New York Air Brake.

Senator NUNN. I am delighted to have a constituent and friend from Georgia. Cordele, Ga. is 38 miles from my hometown. I have known Mr. Griffin and his operation for quite awhile. I just wanted to say a particular note of welcome to Mr. Griffin this morning.

Senator D'AMATO. Mr. Griffin?

STATEMENT OF W. H. GRIFFIN, GRIFFIN LUMBER CO., CORDELE, GA.

Mr. GRIFFIN. Mr. Chairman, Senator Nunn, members of this committee, my name is W. H. Griffin, Jr., president of Griffin Lumber Co. in Cordele, Ga. I am appearing here today in my own self interest and as immediate past president and current member of the executive committee of the Southeastern Lumber Manufacturers Association. SLMA is composed of 398 members in 12 Southeastern States. Our members manufacture roughly 3 billion board feet of lumber per year.

SLMA's position and my position on the safe harbor leasing is straightforward. That is that all businesses, large and small, closely held and publicly held, should be able to take equal benefit of safe harbor leasing and equal deductions for tax credits as well.

From the perspective of owners of small, closely held corporations, there is one overriding issue regarding leasing. That issue is legislative and needs to be addressed and resolved in order for closely held concerns to receive the full benefits of the recently enacted safe harbor provisions.

As implemented, the Internal Revenue Code, section 465, limits the amount of tax deductions that certain closely held businesses may deduct from their taxable income by the amount of money they have at risk in a leasing activity.

A closely held company is basically defined for section 465 purposes as one in which five or fewer stockholders own more than 50 percent of the company.

In addition, the Economic Tax Recovery Act itself extends these at-risk rules which now serve to limit the utilization of investment tax credits as well as tax deductions.

As a result, although the new law does not specifically preclude certain closely held businesses such as mine from participating in safe harbor leasing, the at-risk rules do limit the amount of tax deductions and investment tax credit a lessor may utilize for tax purposes.

Mr. Thomas, Assistant Secretary of the Treasury for Legislative Affairs, stated in a letter to Senator Nunn on December 16: "This means that while some closely held companies are not technically precluded from acting as lessors in a leasing transaction, effectively they may be prevented from doing so by the operation of at risk rules."

Mr. Chairman, these at-risk rules applicable to certain closely held corporations are not applicable to publicly held companies. For example, they have to be only 10 percent at-risk to fully utilize all of the benefits provided for by the law.

It is only equitable and in the national interest that small business, which comprises more than 97 percent of all U.S. companies, which generates 87 percent of all new jobs, and creates approximately 40 percent of the gross national product be given the same Tax Code treatment as is given to the Fortune 500 companies. If the economic rationale for leasing is good for publicly held companies, it is also good for small business.

Mr. Chairman, to put this in perspective, I would like to tell the committee my personal experience in dealing with the leasing provisions.

Like every business person and taxpaying citizen, I watched with a great deal of interest the development of the 1981 Economic Tax Recovery Act. Through the SLMA, the association I mentioned at the outset, I like to feel that I had a small part in the development of this act. Every citizen should feel he has a part in his Government. He will feel that way if he feels his Government is acting fairly and in good faith with those who are governed.

After the President signed this act and made it the law of the land on August 13, 1981, I began to read and study everything I could find relative to it contents. On September 14 I received the September 21 copy of Fortune magazine. In that magazine there was an article by Mr. Richard Kirkland entitled "The Trade in Tax Breaks Takes Off."

At about the same time there was a lead article in the Wall Street Journal dealing with this same subject matter.

I called my CPA that afternoon and took these two articles by to show him. We read them together. By this time there was also beginning to be some treatment of the safe harbor leasing provisions in various tax reporting services he received.

We began to think there was something in this law for Griffin Lumber Co. Our main problem was the timeframe involved. This was September 14. Our fiscal year ended on September 30. We had

2 weeks to find sellers, people with benefits to sell, and to get some leases in place.

Unfortunately, in our area there are sellers. We live in an agricultural area that has been extremely hard hit by drought and depressed farm prices over the past 2 or 3 years. There are any number of farmers, agribusiness related people, and others who have tax benefits they can sell because they are unable to use them.

We found four such people. Every one of them were farmers. They had an aggregate of one-half million dollars' worth of equipment that qualified in all respects. We consummated a leasing transaction with these farmers by paying the required minimums of 10 percent down or $50,000. We had our leases in place before September 30, 1981.

I do not want to get too involved in a very technical discussion here today because you have highly qualified staff to sort out these details for you. However, I do want to get at the very heart of the reason for my appearance here today.

Shortly after these transactions were consummated for the benefit of ourselves and the farmers in our area—as I stated earlier, these farmers certainly need every benefit to which they are entitled—we found there were emerging two sets of rules: One set for large publicly held corporations who are not concerned with the at-risk provisions of section 465 or the investment tax credit risk limitations in the act itself and then rules for the closely held company which is limited in its deductions. He has to be 100 percent at risk to take the full benefit of the deduction.

We had high hopes that we would not be so penalized by the law and regulations. Mr. Chapoton, who led off the testimony here today, said in a speech to the New York Tax Society, as he has referred to in his testimony, that lessors such as ourselves would not be subject to the at-risk rules. He said that on October 5.

However, 15 days later, on October 20, the infamous temporary regulations came down stating that we were subject to these rules and that we were subject of course to the investment credit at risk rules in the act itself.

We already had our leases in place. We were out $50,000. It is true that Treasury probably realizing that this was going to cause some hardship, gave us 30 days to back out of our leases, call them off. Gentlemen, in south Georgia you just do not make a deal in good faith and then back out. It is like buying a mule and 6 days later it gets sick through no fault of the seller and you taking it back and wanting your money back.

We proceeded, decided to go forward, and make the best of a bad situation.

Gentlemen, I know numbers tend to be boring, but I would like to give you one example to demonstrate the effect of being subject to the at risk-rules and not being subject to the at risk-rules.

A small corporation and a big corporation simultaneously enter a $100,000 transaction. Each pays $10,000, the minimum required by law for the lease. The small corporation's first year tax benefit is $5,600. The big corporation's first year tax benefit is $16,900, or roughly three times as much. That is a 300-percent difference.

Now comes the real victim. Mr. Chapoton stated that this does not preclude lessees from entering into transactions and the farmer from selling his benefit. That is true, but what it does do is that if the farmer has a $100,000 piece of equipment—some of these had that and more—and he comes to us for the transaction or we go to him and offer him $10,000 for a first year $5,600 benefit, then the publicly held corporation who does not have these limitations could go to this farmer and offer him $30,000 for the same deal and have an equal transaction.

This happened to us. We had a deal closed with a farmer, or agreed to. We went to him with the $10,000. He informed us that someone had come along and offered him $15,000. This was a publicly held company that could have offered him $30,000.

There was no way that I could explain to him that I was not trying to schanuzzle him. He had a benefit and he could not understand why I could not pay but $10,000 and this guy could pay $15,000. Of course it would have been a little low on my part to try and explain to him that the guy who offered him $15,000 could have offered him $30,000. Then as lessors we would have had equal transactions.

Let me hasten to add that the at-risk rules do not preclude the small business corporation from eventually obtaining all of the benefits that he buys. It only takes him longer.

Since the whole value of this deal to the lessor is predicated on the time value of money, then the deal is just not worth as much. He gets his $5,600 the first year and eventually he gets it all. As I say, the time value of money makes it a vastly different proposition.

Now comes the real victim as I have already stated. What seller would sell to us for $10,000, what he should be able to sell to a public corporation for nearly $30,000. However, the public corporation is not actively buying in our area. Therefore, the farmer and the person with the deal to sell is deprived of an equal market. We in small business are not able to provide the equal market.

Senator NUNN. Mr. Griffin, what you are saying there, as I understand it, is that even though as a theoretical matter the farmer can sell his losses or his equipment under a lease arrangement to General Motors—which is a bad example since they are not making much of a profit now—or to a profitable large corporation, as a practical matter, unless the small businesses that are making profits in the local areas are given equal treatment with large corporations, the people who have losses are going to be deprived because there will not be a market there on those smaller transactions. Is that what you are saying?

Mr. GRIFFIN. That is my judgment, sir.

One of the witnesses—I believe Mr. Chapoton—said that the farmer was not deprived because he could buy his tractor—I was amused at your setting the record straight on the fact that there are no $20,000 tractors left; we closed a deal on a couple of tractors for $65,000—and go to the banks. There is not a bank in our area that would know what safe harbor leasing is. I do not mean to be derogatory, but bankers are not providing lessor services under the safe harbor leasing agreements.

A simple proposal would be to make the at-risk rules applicable to everyone. Our only resentment in this whole thing is that there are two sets of rules. One is applied to big business and one is applied to small business.

I know it is a much used cliche, but we would like to have a level field to play on. I am not here today to pass personal judgment on safe harbor leasing. Congress, in its wisdom, decided that it must have been worthy or they would not have passed it. I tend to agree with the philosophy that it is a worthy tool to stimulate investment. It is the law of the land.

I feel that I am entitled to benefit by that law just as is anyone else. If you decide to repeal it, that will be the law of the land and I will rest on that judgment also. However, I believe, as I said, that it is a worthy tool. I would like to see it apply to everybody.

Thank you for hearing me.

Senator D'AMATO. Thank you, Mr. Griffin.

Mr. Edwards is president of the O. M. Edwards Co. of Syracuse. They have a history of over 100 years in that fair city in my State. I both went to college and law school there. I spent 6 years there and met my wife there. It is a pleasure to have you here and I welcome you here today.

STATEMENT OF HAROLD EDWARDS, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, O. M. EDWARDS CO., INC., SYRACUSE, N.Y.

Mr. EDWARDS. Thank you, Mr. Chairman.

My name is Harold Edwards, Jr., president of the O. M. Edwards Co., which was founded in 1887 by my grandfather, O. M. Edwards. My grandfather was disturbed when he could not open a train window. Therefore, he invented a counterbalanced window which he promptly sold to the Pennsylvania Railroad.

Our main plant is located in Syracuse, N.Y., five blocks from the heart of the city, where we have been for almost 100 years. Some statistics concerning our company are as follows: Sales volume, $13 million; employees, 250; payroll, $4 million. In the last year we purchased $6,500,000 of materials of which $4,200,000 is from small business in New York State. Our fringe benefits are $1,400,000.

Major products are telephone booths for the Bell System, ordered by Western Electric and distributed nationwide; covers and frames, and sheet metal items for the computer market, including such customers as Kodak and IBM. The mainstay of our business consists of doors and windows for city buses, transit cars, rail cars, commuter cars, and over-the-road buses. These products can be found in all major cities in the United States. Specifically, the Metropolitan Transit Authority of New York City has our doors and windows in most of its transit cars, as does Chicago, Boston, Cleveland, Philadelphia, Atlanta, and San Francisco, as well as Washington, D.C.

In the city buses, we are currently supplying prototype sliding windows for General Motors' RTS buses and have high hopes of being the second source for these products. We are also currently negotiating with Grumman Flexible as a second source for their sliding windows.

I am honored and pleased to appear before your Committee on Small Business. The safe harbor leasing, as it relates to public transportation rolling stock, if retained, will have a profound and extremely positive influence on public transit and for jobs for our company.

The transit industry has been starved for capital and the stop and start buying of rail cars has had a devastating effect on the car builders. We have watched with dismay the demise of companies like General Electric in the car building businesses along with Boeing Vertol, Rohr, American Car & Foundry, Pullman Standard, and the St. Louis Car Co. The sole survivor of the old line companies in the United States is now the Budd Co.

The total buses built in the United States averages approximately 3,500 a year, and in view of the needs which are estimated by the American Public Transit Association to be 6,500 a year this is a very small volume. Heavy rail cars were also delivered in small quantities as follows: 1978, 172 cars; 1979, 94 cars; and in 1980, approximately 130 cars.

It is well known that the MTA of New York has a 5-year capital program of over $7 billion to purchase 1,400 subway cars, 200 commuter cars, and 1,600 buses. Safe harbor leasing, relating to rolling stock, will enable New York to obtain $500 million in additional financing to allow them to purchase one additional bus for every nine purchased and one additional subway car for every four subway cars purchased.

The effect of the MTA's $7 billion plan would be to employ 50 people for 3 years at our plant. This would have a tremendous impact on us when our current unemployment in New York State is hovering at 7.3 percent and unemployment in the Syracuse area has jumped from 5.3 percent in 1980 to 7.3 percent in November of 1981. We will be looking into the possible use of tax credits ourselves. We have simply not been too aware of the implications of this.

I now understand that we are prohibited from using safe harbor leasing as five stockholders hold more than 50 percent of our stock. This provision really discriminates against small businesses such as ours.

In addition to its impact on the MTA, the safe harbor leasing provision has already proved beneficial to at least 11 public transit systems, including the systems servicing Los Angeles, Louisville, Boston, Chicago, Philadelphia, Cincinnati, and others.

The recent public announcement that the safe harbor leasing provision would be repealed put in doubt the hopes of these and other transit systems to improve their bus and rail car acquisition plans through the use of this financing technique.

Its repeal would also have an adverse impact on our company.

In conclusion, as a small business tied directly to the bus builders, commuter car and transit car manufacturers, safe harbor leasing, as it relates to public transportation rolling stock, will be a tremendous boon to us and to our industry. This means jobs for our employees and our suppliers who are small businessmen, too.

Thank you.

Senator D'AMATO. Thank you very much, Mr. Edwards.

I am also pleased to be able to welcome for his testimony the president of New York Air Brake, one of our significant, if not the most significant, employers in the northern tier of New York. He is located in Watertown.

Sometimes people think of New York State as New York City and do not recognize its rural nature and its upstate communities. Watertown is a community that has been plagued with chronic unemployment, as your statement points out. Your company and its commitment to New York and to that particular area is of very significant importance. We certainly appreciate your being here, Mr. Willaman, to add your testimony.

STATEMENT OF OWEN WILLAMAN, PRESIDENT, NEW YORK AIR BRAKE CO., WATERTOWN, N.Y.

Mr. **Willaman**. Thank you, Senator.

Mr. Chairman, in the interests of time, I respectfully request your permission to delete portions of my prepared remarks and oral testimony. I further request that the prepared text be entered into the record in its entirety.

Senator **D'Amato**. Thank you very much.

Let me start with Mr. Willaman. I have read your testimony and you make some very, very interesting points. Let me ask you how you see safe harbor leasing as a part of transit equipment financing. I ask you to refer to this document (fig. 1) which you have submitted in terms of what implications it will have both in terms of domestic effects, in terms of international effects, and in terms of the cost of equipment. How will that be felt in all the various areas of our economy, particularly in terms of the public sector and what will we be able to expect in terms of public transportation?

Mr. **Willaman**. Senator, I presented a flow chart that I think illustrates the problem we face. Our problem is that safe harbor leasing favors offshore manufacturing. We find in circle No. 1 (fig. 1), offshore suppliers supplying the transit authorities with the help of export subsidies and interest rate subsidies.

In addition, the transit authorities can turn around and sell the accelerated cost recovery system credits to another U.S. entity. We cannot compete with this combination. My position is that we are exporting employment.

The solution proposed is shown on the righthand side of the presentation. The three circles at the top indicate proposed sources of financing for the transit industry. We are saying we should maintain existing capital grant programs, establish a Federal transit loan bank to offer competitive loans for domestically manufactured transit equipment, and enact a 2-cents-per-gallon highway user charge to fund the capital grant program and the Federal transit loan bank.

We are proposing that in conjunction with these sources of financing we maintain safe harbor leasing for domestically produced transit equipment and institute a 15-percent investment tax credit for domestically produced equipment, in which case we would have the provisions of the safe harbor lease and the investment tax credit flowing through the domestic transit manufacturers who reflect this in lower cost equipment to the transit authority.

Senator D'AMATO. When you say you cannot compete with the lower costs resulting from foreign government subsidization, how is this exacerbated as a result of the safe harbor leasing? Is it exacerbated or is that a problem that exists in and of itself?

Mr. WILLAMAN. That is a problem in and of itself. I think New York City is a good example. They have found that they can go offshore and obtain low cost financing. They are now actively talking with Brazil. The Brazilian Government in essence is saying go to a commercial bank in the United States, borrow the money at the going rate, and we will subsidize it so the net outlay is 8.5 percent.

Then, in addition, when the equipment hits the United States, they can sell the tax credits. We cannot compete with this competition. There is just no way.

We are saying we need something to offset the foreign subsidy. We are saying one of the things that would do that is to deny transit authorities the right to sell their tax credits for foreign produced goods.

Senator D'AMATO. Mr. Edwards, what is your thinking in connection with Mr. Willaman's suggestion?

Mr. EDWARDS. It is very positive.

Senator D'AMATO. I must admit to you that this is the first time that anyone has brought this to my attention. Has the MTA, for example, to your knowledge engaged in any of these transactions to date?

Mr. WILLAMAN. They have not completed any of them, Senator, to my knowledge, but we know they are actively pursuing them in several countries.

Senator D'AMATO. I can tell you this. It will be the subject of some inquiry by this Senator as to whether or not the proposed extension of safe harbor leasing will continue to support mass transit as one of those items that should be retained. I basically believe that safe harbor leasing for mass transit should certainly be retained, but I will entertain the idea of whether or not that proviso that would exclude the foreign purchases and the tax credits as you have described should also be included. That is something that we certainly do not need at this point in time when our own domestic manufacturers are having a great deal of difficulty and would be denied the very opportunity we seek to create, enhancement of our domestic market.

Mr. Griffin, in your opinion, if we do away with the exclusion of closed corporations, as you heard Mr. Chapoton talk about, and give you the ability to also come in as a purchaser, this would open up the market to the small business community. Is this correct?

Mr. GRIFFIN. Yes, sir, I believe so. I believe it would provide a better market for the lessee or user.

Senator D'AMATO. Are you in favor then of retaining safe harbor leasing with the proviso as outlined, that there would be that legislative reform?

Mr. GRIFFIN. Yes.

Senator D'AMATO. We do have two other panels so let me ask this of our two other panelists very quickly: Do you favor basically the retention of safe harbor leasing as it relates particularly to transit financing?

Mr. EDWARDS. Yes.

Mr. **Willaman**. I most certainly do. I think it gives flexibility to sources of funds for financing transit. Their demands for money are horrendous. There just has never been enough available grant money to cover the populous areas such as New York City.

The proposal I have given I think has the flexibility or allows flexibility for sources of capital. It pursues a grant program. That can be phased down as the present administration plans and then be increased incrementally as the revenues pick up. It allows tax-exempt bonds to be sold if the market is favorable. At the current time it is not. That is what sends the transit authority offshore for outside financing. They are trying to buy time and wait until the bond market is more favorable. During those periods, the Federal transit loan bank can issue or guarantee low-interest loans.

Senator **D'Amato**. Let me ask just one other question of this panel.

Mr. Griffin, inasmuch as you have undergone some transactions in terms of the leasing provisions, what were your legal costs and your accounting costs in connection with these transactions?

Mr. **Griffin**. They were not as exorbitant as has been indicated here. Of course it was new this year. Also, of course the quality of the people we had was excellent. That helped. A lawyer down home almost wrote the first one on the back of an envelope and we got one from the final lawyer which was that big [indicating]. Those costs can vary. It depends on how the businessman makes an effort to hold those costs down.

Senator **D'Amato**. What was your largest transaction? Was it $50,000 or $100,000?

Mr. **Griffin**. It was $150,000.

Senator **D'Amato**. On that $150,000 cost could you give us an approximation of what your cost was?

Mr. **Griffin**. They have all been lumped together. I had an accountant's billing and the legal billing. They were not itemized by transaction. We did the whole thing for $7,000 or $8,000.

Senator **D'Amato**. That was out of a total of $150,000 put together?

Mr. **Griffin**. A total of $800,000.

Senator **D'Amato**. I think maybe Mr. Edwards and Mr. Willaman would be interested in your lawyers and your accountants.

Mr. **Griffin**. We could get some just as expensive.

Senator **D'Amato**. Let me thank the panelists for coming in today and making available their expertise. We certainly value your opinions.

Mr. Willaman, we are going to get in touch with you to pursue that legislative protection that we might have an opportunity of enacting into law. I think there are going to be some changes.

Thank you.

[The prepared statements of Mr. Willaman, Mr. Griffin, and Mr. Edwards follow:]

STATEMENT BY P. O. WILLAMAN, PRESIDENT, NEW YORK AIR BRAKE CO. BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS - MARCH 2, 1982

Mr. Chairman and Members of this Committee:

My name is P. Owen Willaman. I am President of New York Air Brake which operates from a single manufacturing plant located in Watertown, New York. Our company is a Unit of General Signal, a New York Corporation. General Signal is a prominent New York State citizen with seven of its thirty-nine operating units located there.

New York Air Brake is a major manufacturer of braking equipment for all types of rail vehicles, both freight and transit. Our current annual sales are approximately $100 million, 90% of which are domestic. We currently employ 1500 people, down from a high of 2000 in 1979 and are the single largest employer in Jefferson County, New York. Jefferson County, I might add, has chronic unemployment with rates higher than anywhere else in the state.

Lease transactions have traditionally provided a significant portion of the capital for railroad rolling stock. During the past three years, approximately 40% of New York Air Brake sales were for vehicles purchased by the railroad industry using such transactions. You may recall the massive freight car shortage which existed in the U.S. during the mid-1970's. Incentives instituted to attract private capital were successful in eliminating the shortage. During 1978, the ICC instituted incentive per diem, a form of surcharge paid by the User to the Owner of certain types of new cars then in short supply. This, plus a 10% investment tax credit and accelerated depreciation, attracted investors resulting in intensive purchase of rail rolling stock in 1978, 1979 and 1980.

The Safe Harbor Leasing provision of the Economic Recovery Act of 1981 provides a nucleus for the incentives needed to attract the capital to finance ongoing railroad and transit equipment purchases. Both industries are capital-intensive. Both are vital to assure efficient movement of commerce and people, and transit in particular is suffering from cash starvation.

The Safe Harbor Leasing provision of the ERTA-1981 is probably the most misunderstood part of the Act. In my judgment, it is not so much a tax dodge for wealthy corporations, as many seem to think -- rather it is more of a tax deferral, and an efficient way to subsidize equipment purchases by marginal or non-taxpaying entities, whereby profitable corporations can postpone tax payments until later years. For example, the marginal entity (the lessee) receives his share of the deferred tax up front. The profitable corporation (the lessor) has a negative cash flow initially (year 1). During years 2 thru 5, the lessor's share of the deferred tax results in a positive cash flow and these monies can be used for working capital needs as his business grows or for capital improvements without borrowing. When the depreciation benefit ends (year 6), the lessor pays tax on the theoretical lease income flowing from the lessee for the remainder of the lease period.

The Safe Harbor Leasing provision promises to be a major incentive to the railroads to purchase new equipment, especially when the current economic situation eases and new rolling stock is needed. Under the previous leverage leasing provisions, railroads were required to purchase the car at its full fair market value at the end of the lease if they wished to retain the asset. This, in effect, required the railroads to purchase the cars twice. Safe Harbor Leasing addressed this problem, a major one for the U.S. railroads whose average rate of return on net investment in 1981 was an underwhelming 4.25% nationwide. The Safe Harbor Leasing provisions allow the railroads to now share the tax benefits, acquire the equipment they need and pay for it only once. Under these provisions, a typical freight car lease involves a 10% investment tax credit, and a five-year write-off, with refinancing after a period of 8 to 12 years. This is very important to them, to us, and to the now severely depressed railway supply industry which employs over 400,000 people in 40 states.

Rail transit brake equipment has also become an important factor in our business. We entered this market in the late 1960's. Since that time, we have provided approximately 25% of all the transit and rail passenger car brake equipment delivered in the U.S. Today, it accounts for approximately 15% of our gross sales. Unlike the rail freight industry where present demand for new equipment is severely reduced, the demand for transit rolling stock exceeds the ability to finance it. Industrial capacity is available to manufacture cars and related equipment. The major problem remaining is financing.

From the enactment of the Urban Mass Transportation Act of 1964, until 1981, Federal capital grant funding rose steadily. Nonetheless, needs for capital funds exceeded the amount available. This has been particularly true in the more populous states such as New York, Pennsylvania, Illinois and to a degree California. Now it appears that plans for the future call for a reduction in Federal funds for capital grants for transit. The Administration's 1983 budget proposes a decline in the Section 3 Capital Grant Program from a peak level of $1.97 billion in 1981 to $1.56 billion in 1983. Assuming a modest inflation rate of 8% per year for 1982 and 1983, the Administration's budget request represents a real drop of 33% in capital grant funding. One effect of this reduction will be to force states and Authorities to seek alternative financing methods for their transit needs. Lacking alternate sources, they will be forced to postpone or abandon necessary maintenance and improvement programs as planned.

As mentioned before, railroads have traditionally gone to the institutional equipment leasing market to finance a significant portion of their new equipment. Until passage of the Economic Recovery Tax Act of 1981 which, among other things, includes mass transit rail cars and buses as "qualified lease properties" and allows public transit authorities to use funds from the sale of tax exempt bonds for leasing transactions, the benefits of leasing were in effect denied to public transit systems. It has been difficult to find adequate funding for capital needs especially for the larger systems. Now, with the level of Federal assistance apparently in decline, some are calling for the end of Safe Harbor Leasing -- a badly needed source of additional capital funding.

To illustrate the serious negative impact its repeal could have on the transit industry, let me cite the situation in New York. As an up-state New York businessman, it is the one familiar to me, but I stress that other cities such as Atlanta, Chicago, Pittsburgh, Los Angeles and Boston face the same circumstances. The New York City Transit Authority (NYCTA) is currently seeking bids on approximately $2.25 billion worth of rolling stock obtaining $480 million from the Federal Tax Leasing provision and utilizing city, state, and/or private funding sources for the remainder. Outright repeal of the Safe Harbor Leasing provision would place this program in jeopardy. Even if left intact, a number of other factors make some revision desirable. Prevailing high interest rates and uncertainty in the bond market have resulted in a loophole whereby the incentives from Safe Harbor Leasing favor foreign goods. The NYCTA, seeking low interest rates, has found that foreign government financing of foreign-manufactured transit equipment, including brakes, is sufficient inducement to make them actively consider foreign procurement. Given the depressed state of our industry, off-shore procurement of this enormous purchase would be a disaster for the American transit suppliers. From a more parochial standpoint, I should point out that the brake equipment associated with this procurement is estimated at approximately $80 million. Furthermore, we are told the NYCTA has plans to purchase a similar amount of brake equipment to be used in the rehabilitation of existing cars. Getting a portion of this business, I am sure you will understand, is vital to us.

Today, the U.S. transit equipment supplier is faced with a proverbial financial triple whammy. UMTA capital funds are on the decline. Last Fall, Congress enacted Safe Harbor Leasing, a promising method of supplementing the decline in Federal grant money, and before the next Spring, there is talk about ending it. High interest rates and an uncertain bond market are inducements for municipalities to look off-shore where foreign governments are eager to subsidize their domestic industries with cheap export financing.

Gentlemen, we are, quite frankly, greatly concerned about the survival of our industry. It has shrunk dramatically in recent years. One cause of this is that a major share of U.S. purchases has been going off-shore. During the 1970's, we saw the domestic transit carbuilders shrink from five manufacturers down to one remaining full line builder. During this same period, two domestic brake suppliers dropped out of the business. Other major suppliers of electrical equipment, air-conditioning, and door-operating mechanisms are believed to be marginal and teetering on the brink of abandoning the market.

We believe that the answer to renewed vitality for the domestic transit industry is a five-pronged program, Federally sponsored, which utilizes both private and government sources to provide the funding. Specifically, we encourage:

First, the continuation of the UMTA Capital Grant Program perhaps at a reduced level as currently planned, with the funding levels increasing as economic conditions improve.

Second, a continuation of the Safe Harbor Lease Provision for transit capital programs but with the incentives available only for the procurement of goods produced domestically.

Third, the availability of a 15% investment tax credit for the domestic content of transit capital programs financed without Federal grants. This, when combined with the Accelerated Cost Recovery System enacted in the recent law, should be a major help to the transit authorities in meeting their capital requirements.

Fourth, the enactment of a 5 to 6 cent per gallon equivalent highway user charge, with 2 cents equivalent targeted for mass transit requirements.

Fifth, the establishment of a Federal Transit Loan Bank. This would serve as a stable source of low interest loans, or interest reducing loan guarantees for U.S. Transit Authorities to allow them to procure domestic manufactured transit equipment. It would augment the programs outlined above by providing an additional source of financing to meet critical capital needs of the major transit authorities. Capital for this bank could be drawn from some portion of the 2 cents a gallon equivalent highway user charge targeted for transit as mentioned above. Further, because the bank would be lending, not granting, its capital would be self-renewing as loans were paid back by the borrower. This concept dovetails with the desire to reduce the dependency of transit capital needs on the Federal Treasury.

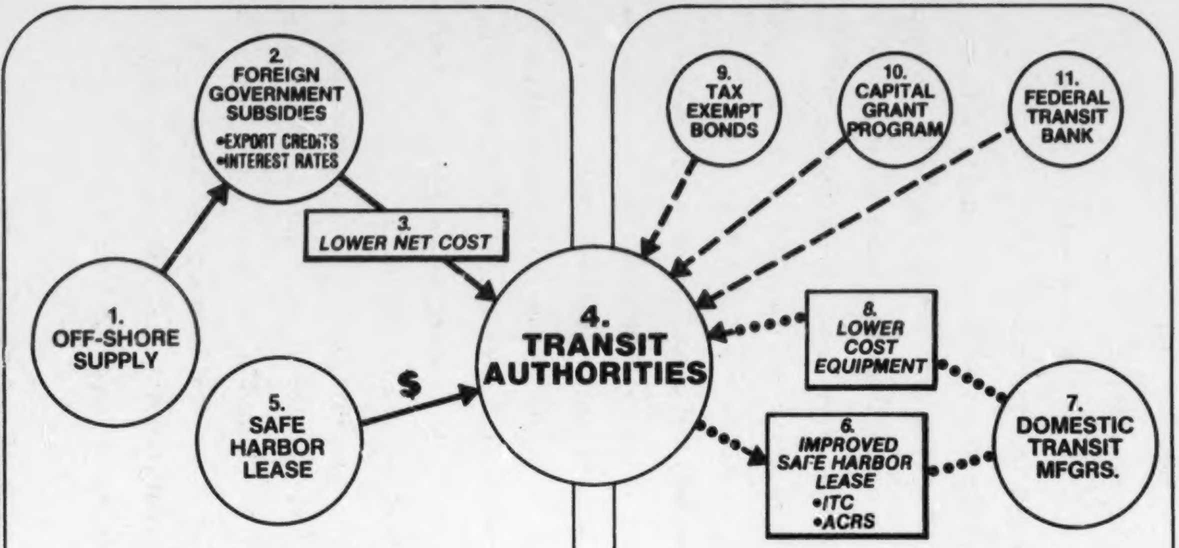
Combined with Safe Harbor Leasing, it would constitute an attractive alternative to foreign government export credits. This, plus the fact that it could be used for domestic equipment only, would strengthen and assure survival of the U.S. transit supply industry.

An additional benefit accruing from the Federal Transit Bank program would be to put the discipline of the private capital market to work to improve the management of public transit authorities, encouraging them to emphasize sound fiscal, labor and administrative policies. Thus, poorly managed properties would be denied loans and would be subject to critical review and reform before capital was made available to them. Lessors would be motivated to exercise similar disciplines to avoid losses which would result from default.

The main thrust of the above program is summarized and graphically illustrated in Figure I attached.

In conclusion, I should like to reiterate that the recently enacted Safe Harbor Leasing provision of the Economic Recovery Tax Act of 1981 is vital to both our freight railroad and rapid transit businesses. It stimulates the needed, timely procurement of railroad freight cars by a low-return-on-capital industry. It would provide a major additional source of funding to domestic Transit Authorities as the levels of Federal capital assistance decline. As part of the five-point capital assistance program that I have described, it can help the U.S. Transit Authorities provide the American people with the excellent public transportation systems they need and deserve. I would welcome any questions.

Safe Harbor Leasing And Transit Equipment Financing


1.
OFF-SHORE
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LOWER NET COST
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DOMESTIC
TRANSIT
MFGRS.
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COST
EQUIPMENT
9.
TAX
EXEMPT
BONDS
10.
CAPITAL
GRANT
PROGRAM
11.
FEDERAL
TRANSIT
BANK

present problem:

SAFE HARBOR LEASING FAVORS OFF-SHORE MANUFACTURERS.

Illustrated above is how Safe Harbor Leasing presently favors goods produced off-shore. Foreign goods are supplied using government subsidized interest rates and other economic incentives. U.S. Transit Authorities sell the benefits of the Accelerated Cost Recovery System (ACRS) to a U.S. taxpayer for additional cash. U.S. manufacturers cannot compete with this combination of foreign credits and domestic ACRS. This in effect is exporting employment.

proposed solution:

A. MAINTAIN EXISTING UMTA CAPITAL GRANT PROGRAM.

B. RETAIN SAFE HARBOR LEASING FOR DOMESTICALLY PRODUCED TRANSIT EQUIPMENT.

C. PERMIT 15% INVESTMENT TAX CREDIT FOR DOMESTICALLY PRODUCED TRANSIT EQUIPMENT.

D. ENACT 2¢ PER GALLON HIGHWAY USER CHARGE TO FUND CAPITAL GRANT PROGRAM AND FEDERAL TRANSIT LOAN BANK.

E. ESTABLISH FEDERAL TRANSIT LOAN BANK TO OFFER COMPETITIVE LOANS FOR DOMESTICALLY MANUFACTURED TRANSIT EQUIPMENT

Figure 1

Diagram accompanying statement by P. O. Wilkerson, President of New York Air Brake Company, before the Senate Committee on Small Business, March 2, 1982.

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Statement by:

W. H. Griffin, Jr.

President of Griffin Lumber Company Inc.

MR. CHAIRMAN AND MEMBERS OF THIS COMMITTEE:

My name is W.H. Griffin, President of Griffin Lumber Company in Cordele, Georgia. I am appearing here today in my own self interest, and as immediate past President and current member of the Executive Committee of the Southeastern Lumber Manufacturers Association, headquartered in Forest Park, Georgia. SLMA was founded in 1962 by a group of independent small business lumber manufacturers for the purpose of solving industry problems. It currently has an active membership of 398 small business lumber manufacturers located in 12 Southeastern States, making it the largest regional association of its kind in the nation. The combined production of our member mills is approximately three billion board feet of lumber annually.

SLMA's position on the Safe Harbor Leasing Provisions of the Economic Recovery Tax Act is straightforward: All businesses, large and small, publicly owned and closely held should be allowed by statute and Treasury Department regulations to participate equally in leasing transactions and to derive like and equal benefits from those transactions.

From the perspective of owners of certain closely held corporations, there is one overiding issue regarding leasing. That issue is legislative and needs to be addressed and resolved in order for closely-held concerns to receive the full benefits of the recently enacted Safe Harbor leasing provisions. As implemented, the Internal Revenue Code, section 465, limits the amount of tax deductions that certain closely held companies may deduct from their taxable income by the amount of money they have at risk in a leasing activity. (A closely held company is basically defined for section 465 purposes as one in which five or fewer stockholders own more than 50 percent of the company.) In addition, the economic recovery act included similar "at risk" rules which now serve to limit the utilzation of investment tax credits as well as tax deductions.

As a result, although the new leasing rules do not specifically preclude certain closely held businesses such as mine from participating in a Safe Harbor Leasing transaction, the "at risk" rules do limit the amount of tax deductions and investment tax credit a lessor may utilize for income tax purposes. As Mr.W. Dennis Thomas, Assistant Treasury Secretary for Legislative Affairs said to Senator Nunn in a December 16, 1981 letter, "This means that while some closely held companies are not technically precluded from acting as lessors in a leasing transaction, effectively they may be prevented from doing so by the operation of at risk rules."

Mr. Chairman, these "at risk" rules applicable to certain closely held companies are not applicable to publicly held companies, i.e., the large publicly held company only has to have 10% "at risk" to fully utilize these tax benefits while certain closely held business must have 100% "at risk" to fully utilize the investment tax credit and related tax deductions. It is only equitable, and in the national interest, that small businesses which comprise more than 97 percent of all U.S. companies, which generate 87 percent of all new employment, and create approximately 40 percent of the gross national product be given the same tax code treatment as are Fortune 500 companies. If the economic rational for leasing is sound, it is not just sound for big business, but for small business as well.

Mr. Chairman, to put this in a realistic perspective, I would like to tell the Committee my personal experience in dealing with the leasing provisions in the 1981 Tax Act.

Like every business person and tax paying citizen, I followed with a great deal of interest the developement of the Economic Recovery Tax Act of 1981. Through the SLMA, a trade association mentioned at the outset, I like to feel that I had a small part in helping shape this legislation. This is how every citizen should feel toward his government and he will feel that way if he believes that his government is responsive and fair in its dealings with those who are governed.

After the President signed this Act and made it the Law of the Land on August 13, 1981, I began to read and study everything I could find relative to its contents. I began to encounter repeated references to a new code section 168(f)(8) having to do with new rules for leasing, and the term Safe Harbor leasing provisions of the new Tax Act.

On September 14, I received my September 21st copy of Fortune magazine which contained an article entitled "The Trade in Tax Breaks Takes Off" by Richard Kirkland. At about the same time there was a lead article in the Wall

Street Journal entitled "New Tax Law Makes Once Unusable Credits a Boon for Many Firms". This article was by Misters Leonard Apcar and Robert Merry.

I called my C.P.A. on Monday afternoon, September 14th, showed him the two articles. There was also by this time beginning to be some comments on Safe Harbor Leasing in the various tax reporting services which he receives.

We decided that maybe there was something there for us. Our primary problem was the time frame involved. Our fiscal year ended on September 30th so we had two weeks to locate someone with tax "benefits" to sell because our desire was to go in on the "buy" or "Lessor" side.

We found that sellers, (Lessees), were available because we live in an agricultural area that has been particularly hard hit over the last two or three years by drought and depressed farm prices. Before the end of our fiscal year end on September 30th, we found four sellers with an aggregate of $500,000.00 worth of equipment that "qualified" in all respects willing to enter into a sale and leaseback within the Safe Harbor Rules. We consumated the transactions with the down payment of approximately $50,000, the minimum 10% investment required.

I don't want to get too involved in a very technical discussion here today because you have highly qualified staff to sort out these details for you. But I do want to get at the very heart of the reason for my appearance before this committee today.

Shortly after these transactions were consumated for the mutual benefit of ourselves and the farmers in our area, who desparately need any and every benefit to which they are entitled, we found that there was emerging two sets of rules. One set for large publicly held corporations. They are not concerned with the "at risk" limitations imposed by code section 465. They also are not concerned with the investment credit "at risk" limitations imposed by the Act itself. These limitations are imposed on corporations that are closely held as defined at the outset of my testimony. My company is well covered by this definition.

We had high hopes that we would not be so penalized. Mr. John Chapoton, Assistant Secretary of Treasury for Tax Policy, said in an October 5th speech to the Tax Society of New York University that purchasers like ourselves would not be limited by the at risk rules from claiming the credits and deductions that would have been available to the seller.

Then on October 20th, 15 days later, the infamous temporary regulations came down stating that we were subject to all of the limitations imposed by Section 465.

We already had our leases in place and had advanced approximately $50,000, so we had to go forward and make the best of a bad situation. While it is true that the temporary regulations gave us 30 days to back out and unwind our deals, you just don't renege on deals made in good faith and maintain your integrity in South Georgia. I have an idea that holds true in other parts of the country also.

Gentlemen, I realize that numbers tend to be boring, but I need to give you one example to show the difference in being subject to and not being subject to the at risk rules.

Big Corporation and Small Corporation, both of which are in the maximum federal income tax bracket, simultaneously enter a leasing deal as Lessors, on $100,000.00 worth of 5 year ACRS equipment. Both pay $10,000.00 cash (minimum required by the Act) and give a $90,000.00 note for the balance.

Small Corporation can realize $5600.00 in cash resulting from tax benefits the first year; $4600.00 from $10,000.00 of 1st year depreciation, and $1000.00 in Investment Tax Credit.

Big Corporation can realize $16,900.00 in cash resulting from Tax Benefits the first year; $6900.00 from $15,000.00 of 1st year depreciation and his total $10,000.00 investment tax credit. Big Corporation's first year benefit is roughly three times the benefit of Small Corporation's benefit. Gentlemen, that is not just retoric, it is fact.

Let me hasten to add that the "at risk" rules will not prevent Small Corporation from eventually realizing all of the benefits that he purchased. It will just take him longer to realize these benefits. Since the whole basis for tax benefits to a lessor is predicated on the time value of money, the lease is just not as valuable to the Small Corporation who is a lessor.

Now comes the real victim of the unfairness of this situation. If Small Corporation can only pay $10,000.00 for the $100,000.00 deal and realize $5600.00 the first year, then Big Corporation who can realize $16,900.00 the first year should be willing to pay $30,178 for the $100,000.00 deal. Now, what seller would sell to us for $10,000.00 what he should be able to sell for $30,178.00 to a publicly held corporation. Yet the publicly held corporations have shown no interest in small transactions. So you see the sellers in our area are being deprived of an equal market, when we, Small Business, are not able to provide that equal market.

In summary let me say that I am not here today to pass personal judgment on Safe Harbor Leasing. Personally, I tend to agree with the philosophy that it is a worthy tool to stimulate investment. Congress, in its wisdom, must have thought so too or it would not have passed it. However, I do take strong exception to the two sets of rules that the game is being played by. A very simple solution would be to impose the "At Risk" limitations to public corporations also. This would in no way affect the total cost to the Treasury over a period of time but it would be smaller cost in the immediate years.

Gentlemen, Thank You for hearing me.

TESTIMONY

by

HAROLD EDWARDS, JR., PRESIDENT OF THE O. M. EDWARDS COMPANY, INC., SYRACUSE, NEW YORK

My name is Harold Edwards, Jr., President of The O. M. Edwards Company, Inc., which was founded in 1887 by my grandfather, O. M. Edwards. My grandfather was disturbed when he could not open a train window and, therefore, he invented a counter-balanced window which he promptly sold to the Pennsylvania Rail Road. Our main plant is located in Syracuse, New York, five blocks from the heart of the city, where we have been for almost one hundred years.

Some statistics concerning our Company are as follows: sales volume--$13 million; employees--250; payroll--$4 million. In the last year, we purchased $6,500,000 of materials of which $4,200,000 is from small businesses in New York State. Our fringe benefits are $1,400,000.

Major products are telephone booths for the Bell System, ordered by Western Electric and distributed nation-wide; covers and frames, and sheet metal items for the computer market, including such customers as Kodak and IBM. The mainstay of our business consists of doors and windows for the city buses, transit cars, rail cars, commuter cars and over-the-road buses. These products can be found in all the major cities in the United States. Specifically, the Metropolitan Transit Authority of New York City has our doors and windows in most of its transit cars as does Chicago, Boston, Cleveland, Philadelphia, Atlanta, and San Francisco, as well as Washington, D. C. In the city buses, we are currently supplying prototype sliding windows for General Motors' RTS buses and have high hopes of being the second source for these products. We are also currently negotiating with Grumman Flxible as a second source for their sliding windows.

I am honored and pleased to appear before your Subcommittee on Small Business. The "Safe Harbor Leasing" as it relates to public transportation rolling stock, if retained, will have a profound and extremely positive influence on public transit and for jobs for our company. The transit industry has been starved for capital and the stop and start buying of rail cars has had a devastating effect on the car builders. We have watched with dismay the demise of companies like General Electric in the car building business along with Boeing Vertol, Rohr, American Car and Foundary, Pullman Standard and the St. Louis Car Company. The sole survivor in the United States is now the Budd Company. The total buses built in the United States averages approximately 3,500 a year and in view of the needs, which are estimated by the American Public Transit Association to be 6,500 a year, this is a very small volume. Heavy rail cars were also delivered in small quantities as follows: in 1978 - 172 cars; 1979 - 94 cars; and in 1980 approximately 130 cars.

It is well known that the MTA of New York has a five-year capital program of over $7 billion to purchase 1400 subway cars, 200 commuter cars and 1600 buses. Safe Harbor Leasing,relating to rolling stock, will enable New York to obtain $500,000,000 in additional financing, which will allow them to purchase one additional bus for every nine purchased and one additional subway car for every four subway cars purchased.

The effect of MTA's $7 billion plan would be to employee 50 people for three years at our plant. This would have a tremendous impact on us when our current unemployment in New York State is hovering at 7.3% and unemployment in the Syracuse area has jumped from 5.3% in November 1980 to 7.3% in November of 1981. We will be looking into the possible use of tax credits ourselves and we have simply not been too aware of the implications of this.

In addition to its impact on the MTA, the "Safe Harbor Leasing" provision has already proven beneficial to at least 11 public transit systems including the systems servicing Los Angeles, Louisville, Boston, Chicago, Philadelphia, Cincinnati, and others.

The recent public announcement that the "Safe Harbor Leasing" provision would be repealed put in doubt the hopes of these and other transit systems to improve their bus and rail car acquisition plans through the use of this financing technique. Its repeal would also have an adverse impact on our Company.

In conclusion, as a small business tied directly to the bus builders, commuter car and transit car manufacturers, safe harbor leasing, as it relates to public transportation rolling stock, will be a tremendous boon to us and to our industry. This means jobs for our employees and all our suppliers who are small businessmen too.

Senator D'AMATO. Inasmuch as I think there is going to be a vote coming up, we are going to take a 10-minute recess before we continue with our other panelists.

[Recess taken.]

Senator D'AMATO. The committee will reconvene.

We have Mr. John Fitch, Jr., vice president, government relations, National Association of Wholesaler Distributors; Mr. James McCarthy, vice president, General Business Services; and Mr. Robert Haddad, senior tax manager, Price Waterhouse.

Gentlemen, thank you. We are running a little late and I apologize. We have another vote coming up so I think we will try to get in as much of your testimony as we possibly can.

Mr. McCarthy.

STATEMENT OF JAMES B. McCARTHY, VICE PRESIDENT, GENERAL BUSINESS SERVICES

Mr. McCARTHY. Good morning. My name is Jim McCarthy. I am vice president of General Business Services of Rockville, Md.

I am here today representing the National Small Business Association, which is a multi-industry trade association founded in 1937 and now represents about 50,000 small businesses nationwide.

My company, GBS, is a firm that operates through about 1,200 franchise business counselors in all 50 States. We offer tax return preparation, recordkeeping, and business counseling services to the smaller spectrum of the small business community.

Our clients are retailers, professional brokers, Century 21 persons, Farrell's Ice Cream Parlors, and so on. Most of our clients will have 10 or fewer employees. We do not publish the exact number of our clientele, but we do many, many thousands of tax returns here in the Rockville area for small business persons throughout the Nation. To date, I have not found one who has taken advantage of the safe harbor leasing provisions.

The NSBA has taken the position in its submission, which I would like to have be made part of the record, that the existing provisions of the law, because of the statute, the regulations, or maybe an interpretation of both, have precluded small business participation in the safe harbor leasing provisions. We move that the changes be made. In our presentation we have made specific recommendations as to the changes needed to the statute and to the regulations.

Beyond that I would like to comment on my opinion as to the real impact on the small business community even if these changes are made. There are approximately 10 to 11 million small businesses in the United States right now. Most, of course, are sole proprietorships. Of that number, probably 70 to 80 percent have assets of less than $200,000.

In my investigations as to these leasing provisions, I have not found any lessors who are brokers who would recommend deals of less than a half million dollars at this time. No matter how we change this, it seems to me that most of the small business community, 70 to 80 percent, will not likely ever be able to participate in safe harbor leasing.

Finally, at one time 30 percent of our tax revenue came from corporate taxpayers. It is now down to 10 percent. More and more reliance is being made on the individual taxpayers to carry the tax burden. To do this, these persons have to have faith in the integrity of the system.

There is an ever growing so-called underground economy. People are cheating on their taxes. They rationalize to themselves when they cheat on their taxes that the tax law is unfair, that it favors the big guy over the little guy.

In recent times I have not seen a better example of a statute that has been more misinterpreted by the general public and has been held up as a sample of tax provisions that help the big guy over the little guy.

Thank you.

Senator D'AMATO. Mr. Haddad?

STATEMENT OF ROBERT HADDAD, SENIOR TAX MANAGER, PRICE WATERHOUSE, BOSTON, MASS.

Mr. HADDAD. Thank you, Mr. Chairman.

My name is Robert Haddad. I want to thank you for the opportunity to appear here today. I am a senior manager with Price Waterhouse in Boston. I am speaking to you today on behalf of SBANE, a small business organization representing a regional coalition of business persons and their concerns.

In light of the time constraints we are facing today, I have submitted more detailed testimony and will just summarize the issues that we think are important for discussion.

The first involves the at-risk provisions. I would just like to repeat a little bit of what was said this morning regarding the fact that not only Congress but Treasury Secretary Regan and Assistant Secretary Chapoton clearly have articulated the position that formation companies as well as all other companies are intended to benefit by the safe harbor leasing provisions.

As was stated this morning and fortunately corrected subsequently, the Treasury's initial position was that the purchaser or lessor of tax benefits would not be able to benefit unless the at-risk provisions were met. This was carried through in the regulations. As we have discussed this morning, the closely held companies were, in fact, precluded from participating unless they met the at-risk requirements at the lessor and lessee level.

It has been stated that it will be corrected. We believe a technical amendment should be put in place to eliminate this inequity. It is important for reasons I will discuss in a minute for a lot of small businesses, especially in our constituency, which probably amounts to 2,000 small businesses which are in our organization.

There is a second area I would like to briefly mention. It has to do with the disqualification rules for lessors. This is something that has not been brought up this morning. It is not necessarily a critical issue, but in structuring these deals it would seem that a group of small corporations would be interested in forming a partnership in order to be able to get into a larger deal and buy some benefits.

One of the problems is that the regulations would cause the disqualification of the entire transaction if one of the participants were for some reason to make a mistake, or disqualify himself, or his entity.

We think that some remedial action may be appropriate if we are to continue with safe harbor leasing and change the at-risk provisions.

A final area that we think should require some change was mentioned this morning. We are very concerned about it. I think Mr. McCarthy just alluded to it. It is the individual lessor or proprietor situation. They are precluded from participating as lessors. A significant number of the small businesses in this country are not corporations necessarily.

We believe that some adjustment or change should be made to enable them to participate in the safe harbor transactions.

As to the availability in the marketplace and economics, Mr. Baird, one of our members on the tax committee at SBANE, did an oral survey, telephone and letter if you will, of New England businesses, banks, and financial institutions. We have submitted the results in our testimony.

The economics of the transaction clearly indicate—I think everybody agrees—that you can get a cheaper borrowing rate by entering into a safe harbor transaction if you are able to subject to the at-risk provisions. Also, there is a genuine interest on the part of those people who would be involved as lessors, that is the banks and other individual or collective corporate entities that would be interested in getting involved in the buy side of these deals. There clearly is a market for the small company to participate in these transactions from an economic standpoint.

In one conversation I had with a major Boston bank with over $3 billion in assets, we think there is room to minimize once the initial reaction to what it is all about. I think the legal and accounting fees can be reduced substantially.

That bank was buying the credits itself as well as being the third party in the transactions. They happen to be a bank that was profitable and able to use them.

I think the fact of the matter is that the economics when we get to the legal and accounting fees, as in every deal, are always very difficult up front to interpret the committee reports, Treasury regulations, and so on. I think once the dust settles it is clear that there is a benefit that can be obtained.

One example we ran reduces the cost of borrowing from 18 percent to 11 percent. That is what small business needs. Whether this is the vehicle or not, we do not know.

Before my closing comments, I would suggest that both Secretary Chapoton's comments and Assistant Secretary Glickman's comments last Thursday reiterated a point that we think is the result of our survey, that is that the 85 percent or 90 percent of the information returned deal with leases of less than $100,000. We submit that if they were not economical they probably would not have been entered into. Already there has probably been some legal and accounting interpretation.

It is like when incentive stock options came up. The first ones through are not the small companies. Now the small companies are looking into them when the dust settles and it does not cost them a lot of money to get going and set up.

It is not uncommon. We believe it is feasible. Our survey indicated it is feasible.

In conclusion, to implement the full force and effect of safe harbor leasing rules, we respectfully suggest that technical amendments in the law be made with regard to the following areas: Discrimination against closely held corporations, disqualification of lessors, preclusion of sole proprietorships as sole lessors.

If these changes are made, small business persons will be able to utilize more effectively the benefits of safe harbor leasing and will thus be more productive and be able to invest in capital formation.

Thank you.

Senator D'AMATO. Thank you very much.

Mr. Fitch?

STATEMENT OF JOHN FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, WASHINGTON, D.C.

Mr. FITCH. Thank you, Mr. Chairman.

As the other two witnesses have indicated, I would like to submit my full statement for the record and just summarize it.

I would also like to spend some time dealing with Mr. Chapoton's analysis of leasing in general. First, I would like to say that NAW very definitely support the safe harbor leasing provisions of ERTA. We think it is an excellent marketplace fix for corporations who are in a marginal or less than profitable situation to get present value for their unused investment tax credits and depreciation allowances.

I find it consistent with the productivity incentives of the administration's economic recovery program which say that in order to participate in the productivity benefits of ERTA, you should be allowed to use some of the tax benefits related to it.

We agree that the safe harbor leasing provision is good and can be utilized by small business; however, the problem as we see it, is that the Treasury Department has administratively applied the 465 rules to the lessor. Testimony on the House side last week by the American Institute of CPA's confirmed this. We do not see the need for legislative action to correct this. We think the Congress should implore Treasury to make the correction administratively in their temporary regulations.

While their position not to oppose any legislative remedy is cooperative, the realities of achieving any legislative remedy with regard to this situation are much greater than an administrative correction.

Second, if the committee examines safe harbor leasing closely, you will find how interrelated it is to the accelerated cost-recovery system. If leasing is repealed, it will leave vulnerable many small businesses with accumulated ITC's or ACRS deductions as targets for takeover. These are tax-related takeovers, not competitive related takeovers. In that sense, repeal of safe harbor leasing is bad public policy.

Therefore, if leasing is repealed, it must be replaced with some other mechanism. However, leasing does in fact perform the function very well.

Mr. Chapoton's characterization that small business is utilizing leasing is specious at best because he is using the lease transaction amount as the determining factor. I think he quite correctly pointed out that without an examination of the parties involved in leasing, you cannot make a statement that small business is utilizing leasing.

Senator D'AMATO. Mr. Fitch, I am going to have to beg your indulgence and that of the panel in that I have about 4 minutes to make another vote.

Senator Nunn will continue the meeting when he returns. We will take a brief hiatus until then.

[Recess taken.]

Senator NUNN [acting chairman]. I have been informed that Chairman D'Amato is on his way back, but he has asked me to go ahead.

Mr. Fitch, had you started your statement yet?

Mr. FITCH. Yes.

Senator NUNN. Please proceed then.

Mr. FITCH. In the interest of time, I will finish up my oral presentation.

One other point that Mr. Chapoton made which I think needs to be addressed is the fact that the Treasury Department has no definition for small business. I find it quite ironic that Treasury indicated small business is utilizing leasing and yet they do not even have a definition for small business.

Mr. Chapoton also indicated that the full utilization of leasing to an unincorporated small business without 465 at risk would run into problems related to the rate differentials; that is, unincorporated businesses pay taxes accordingly to the individual rate scale.

I would just like to point out that there is a graduated corporate tax scale that must be taken into account on the lessor side as well.

I do not think the argument is very persuasive.

Senator NUNN. In fact, after the 3-year tax provisions are fully implemented, the corporate maximum will not be much different than the individual maximum.

Mr. FITCH. That is right.

Last, at the end of my statement I have developed a flow chart to show how the at-risk rules would apply to small business. I think it quite dramatically shows the inequity involved, at least on the lessor side.

That is all.

Senator NUNN. Did you have an alternative that you proposed? I was not here for the first part of your testimony. Did you have any alternative that you proposed for leasing in lieu of repealing it?

Mr. FITCH. Yes, Senator. While NAW supports leasing, given the political environment surrounding leasing, we do not know whether its survivability is very predicatable at this point.

However, I think there is a need to have some marketplace mechanism to give present value for unusable investment tax credits for those people who want to participate in the productivity incentives the administration has proposed.

I agree with Mr. Chapoton that refundability causes a lot of problems. First, there are the administrative costs related to refundability. Second, a small businessman cannot take advantage of refundability until he files his tax return.

My alternative is this: You have a 15-year carry forward already in the law. You can apply your accelerated cost recovery allowance forward for 15 years even though your present value has diminished somewhat.

However, with regard to the investment tax credit, you could allow its free market buying and selling. It would preserve the concept of leasing in the sense that you would get present value for your unused investment tax credit.

For example, say you have a small businessman who makes capital purchases and who has $20,000 of unused investment tax credit available. Under my proposal he would offer those for sale to the highest bidder in the open market. When somebody over here says: "I need $20,000 worth of investment tax credits." They strike a bargain.

There is no Government involvement. The small businessman who needs the $20,000 in cash flow can get present value right then and there for those unused tax credits. He does not have to wait for another year and a half or so when he files his tax return to get the benefit as with refundability.

Because you have eliminated ACRS depreciation from the equation, you would reduce the cost to the Treasury without putting the Government into the transaction as you would in the refundability area.

Senator NUNN. Would you apply that to individuals as well as corporations?

Mr. FITCH. Absolutely. Anybody. Anybody who has unused investment tax credit could buy and sell at will.

Senator NUNN. Would you have a brokerage function by the Federal Government as suggested by Mr. Janeway?

Mr. FITCH. No. I do not agree that SBA or any other Government agency should be in the brokerage business in this regard. I think the free market can take care of it: Accountants, lawyers, stockbrokers, money market operators, banks, anybody would be able to provide that function at a reasonable price.

Senator NUNN. Has there been any precedent for this kind of purchase of tax losses, other than through merger of corporations, that you know about?

Mr. **Fitch**. Not that I know of.

Senator **Nunn**. What do you do, for instance, with the practical problem of verifying whether the tax loss is legitimate if you are a company buying the tax loss so that you do not end up buying something that ends up being proved to be not valid, that the taxpayer was not entitled to it?

Mr. **Fitch**. If I am not mistaken, under current IRS regulations, you have to show a bill of sale or some evidence that you in fact made the capital purchase. I require that such a bill of sale or notarized statement be attached to the ITC contract sale agreement with whomever you sold your investment tax credit to; that would be evidence to the fact that you made that purchase and were entitled to the deduction.

Senator **Nunn**. What I am saying is suppose company A or individual A claims $100,000 tax loss and sells it to company B for, say, $50,000. Then company B takes that $100,000 tax loss on their return; 2 years later when their return is checked, the Treasury Department asks, 'Who did you buy it from?'

They say: "Company A sold it."

Then Treasury says: "We have checked company A and they really did not have that kind of tax loss."

It seems to me you are incorporating somebody else's tax loss. What would be the liability of the purchaser if the tax loss in effect turns out not to be legitimate?

Mr. **Fitch**. No more than under present law. I think a reasonably prudent buyer would want to make sure that what he was buying the seller was legitimately entitled to. I think that is something that reasonable people in the business community do every day. I do not see any additional need for any safeguards.

Senator **Nunn**. You are saying just that pertaining to the investment tax credit.

Mr. **Fitch**. Yes, sir.

Mr. **Haddad**. If I could just clarify that, the tax credit itself is a creditable item. Selling the loss, which Mr. Janeway brought out this morning, seems to mean to sell the bottom line loss as you indicated, Senator, of a company. Let us say it had a $100,000 loss which would have been caused by ACRS, high-interest cost, and operations. That has nothing to do with the sale of credits which is a separate and distinct piece of sale.

What I think John is proposing is selling the credit and not selling the losses. What Mr. Janeway was proposing was selling the losses.

I agree with your observation. If you are dealing with selling the losses of a company, there are significant complications under the existing law for sure. There is a provision in the law that says you cannot buy a company for its losses, which I presume logically extends to buying the losses of another entity. That is the whole acquisition scene.

On the other hand, I would like to get back to the question of a comparable situation. You can under existing leasing deals. If you were to go to buy a piece of equipment, in the terms of the lease generally you would get two pieces of paper, one which would say here is the lease with the tax credit being passed through to you and here is a lease without the tax credit. The difference would be in the amount of rental you would pay. There are adjustments built into the system right now today that would accommodate that kind of situation in the leasing environment.

Mr. **Fitch**. To me it sounds like a reasonable and viable alternative to leasing while still conserving the concept of leasing, that is a free market utilization of the tax benefits given present value.

Senator **Nunn**. That would certainly open it up for small business.

Mr. **Fitch**. Absolutely.

Senator **Nunn**. Mr. Chairman, I went ahead. At this stage I think all the panelists have testified. I have asked my questions. At this point I will turn it back over to you.

Senator **D'Amato**. Senator, thank you for resuming the hearings. I apologize to the panel and to those who are waiting to testify.

Let me ask a few questions. Do you really think it would be better with the present law as it is now in existence—I am talking about small business and yourselves—or with the elimination of the sale of losses as it presently exists, the safe harbor provisions as they presently exist?

If you had your druthers, if you had a choice, would you continue the present program or abolish it? What would you say?

Mr. **Haddad**. If I could respond to that, it seems to me that continuing the present program for purposes of stimulating the economy would make more economic sense than abating the program. That is just from a pure economic standpoint and directly assuming you will have a benefit that will trickle down to the small business person. That would be my reaction to that question.

That is not to say that if you were to offer the option of safe harbor leasing for purposes of the small business person or some other alternative, whether it be a small business participating debenture or something, then I would think I would have a different answer to that question.

Senator **D'Amato**. Mr. McCarthy?

Mr. **McCarthy**. We feel the existing safe harbor leasing provisions should only be continued if the changes we have suggested are enacted to make it available to everyone.

Senator **D'Amato**. Does that everyone include the individual entrepreneur?

Mr. **McCarthy**. Yes.

Senator **D'Amato**. Supposing we make it available to the lessor and we deal with the problem of the closely held corporation, but not make it available to individuals, to individual entrepreneurs. What is your position then?

Mr. **McCarthy**. I would seriously think we should kill the whole thing if it is not available to everyone.

Senator **D'Amato**. Would you care to expand on that at all?

Mr. **McCarthy**. I would like to add one more thing that I do not think I made clear when I was speaking earlier. NSBA is definitely in favor of making these changes so it is available to everyone.

The second question is even with these changes being made to what extent will the small business community be able to use it when you consider the 8 million or so proprietors. We took the position that we did not think that many small businesses were using it now. It kind of conflicted with what appeared to be the testimony of the Treasury where the results of their initial study indicated that a lot of small deals were being written now.

Senator **Nunn**. I would have to see a lot more backup before I believe that.

Mr. **McCarthy**. Take a look at their testimony. Their testimony was changed today from the testimony they made last week over at the House. If you read it carefully, they say most of these smaller transactions cover property worth less than $100,000 and involve straight or leverage leases, that is leases in which the lessee does not sell the property to the lessor.

I think what they are talking about is when the people got this new form they filled them out for leases involving plain old lease-purchase arrangements where I leased you a Xerox machine. I do not think they involve leverage leases at all.

I do not think we have any activity in the small business community now involving small deals. I do not think we will have any activity even after these changes are made when you look at about 80 percent of the small businesses who are going to have total assets of less than $200,000.

Senator **D'Amato**. In your opinion then——

Senator **Nunn**. Mr. Chairman, could we get the staff to write a supplemental set of questions for the record? I asked for certain information for the record. In order that we get a full informational base from Treasury I think we really have to have that.

Senator **D'Amato**. I might indicate to the Senator that during Mr. Chapoton's testimony I asked him to try to identify the number of businesses using safe harbor leasing that employed fewer than 500 people for the record. He indicated he would do that so we could get a breakdown in terms of the kinds of businesses that are involved in this.

He indicated he would need to the end of the month. I would ask staff to be quite precise in following up with a series of questions in terms of these numbers and in terms of what the average lease involved was, et cetera, so we can get some definitive answers.

Mr. **McCarthy**. You are going to find that 70 or 80 percent of all the small businesses in the United States employ less than 10 or 12 people.

Senator **D'Amato**. We started with 500. We can break that number down and get it down as low as 50 or some other number if that is discernible in terms of those submissions, the leases, or the documentation that is submitted. We would like to try to get as accurate a breakdown as we possibly can get with whatever they have statistically.

Mr. **Fitch**. Mr. Chairman, I would like to comment on that point also.

I think the fact that the availability of leasing, according to Mr. Chapoton, to small business as lessees is strongly mitigated by the fact that the closely held corporations on the lessor side are limited by the at-risk rules. That is, the natural buy is between a small business lessee and a small business lessor.

To go even beyond that, the fact that the 465 issue should be applied to the lessor at all by the statute, that is sub S partnerships and sole proprietorships cannot be lessors—further inhibits the utilization of leasing by small business. I think the whole issue needs to be looked at.

Senator D'AMATO. If I heard Mr. McCarthy right, he said even if we addressed the problems of the lessors as it relates to closely held corporations, he would still have difficulty supporting the safe harbor lease provisions as a result of their excluding the vast bulk of small business entrepreneurs, those who do not have any corporate structure whatsoever.

Is that fair, Mr. McCarthy? I do not mean to be saying something you are not saying.

Mr. MCCARTHY. That is exactly correct.

Mr. FITCH. That is not my position. My position would be somewhat similar to Mr. Griffin. I think Mr. Griffin pointed out that the small business lessors can provide capital for small business lessees if they are allowed to take full advantage of leasing.

I think the potential is there.

Senator D'AMATO. We heard Mr. Chapoton say that the Treasury would be willing to support that, at least not to oppose it, to tacitly give support and to help in the drafting of legislation that will accomplish that aim.

Then we come down to the basic problem. I wish he were here and I wish Mr. Janeway were here to get down to the real heart of it. There is a $33.6 billion loss projected for the Treasury. Is that going to give dividends by way of increased business activity and job production and stimulation to the economy that is worth the increase in the deficit over a 5- or 6-year period of time?

The one area that I can identify that certainly should be retained in my mind is in the area of mass transit leasing. I think one of the suggestions put forth was to make sure that these were not benefits that were then taken advantage of by foreign corporations. I think that is important.

Mr. FITCH. If you will notice, State and local governments are now beginning to take advantage of leasing to provide cash flow supplements to the Federal budget shortfall.

Montgomery County, as the Post reported a couple of weeks ago, leased buses to a corporation in exchange for cash. I think as leasing permeates down through society to the grassroots level you are going to see much more utilization of it. I think that will in fact stimulate productivity.

Mr. MCCARTHY. You talk about public reaction to this provision in the bill. My principal economic advisor is an owner of a bar out in Rockville to whom I talk on occasion.

Senator D'AMATO. You just talk to him on occasion?

Mr. MCCARTHY. I just talk to him.

Senator D'AMATO. On the telephone or in person?

Mr. MCCARTHY. Oh, no, in person.

Senator D'AMATO. At his place or your place?

Mr. MCCARTHY. At his place. He happens to be an ex-Metro bus driver who bought this business. He has this negative attitude toward all the depreciation changes and this change because, again, it is a law for the big guy versus the small guy.

He believes that these Rockville minibuses only exist because they can pay wages to these drivers that are much smaller than they have to pay to the Metro bus drivers. His reaction was this was another way the Government is subsidizing low wages for these local bus drivers.

Mr. **Haddad**. If I might add, I think we ought to be careful. I know we are all groping for facts and information here. We should distinguish between a small business that is a proprietorship that runs a retail ice cream store or a hamburger stand where there is a one-time capital investment versus a small manufacturing or light assembly plant that may be profitable or may not be profitable.

It is important maybe from my own standpoint at Price, Waterhouse. We are removed sometimes from the very small operation. On the other hand, we are clearly familiar with the fact pattern in the small manufacturing reasonable successful entity that is holding up on capital acquisitions because of high finance costs that is showing a profit that is really a phantom profit, that is paying taxes and depleting their working capital right now today even with the benefit of ACRS and being able to utilize it.

On the other side we have a situation where one of our clients, a group of small businessmen who formed up over a 3-year period, were able to develop a hydroelectric project and have been nothing but stuck. As a matter of fact, we are currently trying to examine how to dispose of the business because of the problems the ACRS has created.

Senator **D'Amato**. Is that up in the New England area?

Mr. **Haddad**. Yes, it is.

Senator **D'Amato**. I knew a New Yorker who is going into partnerships and buying some of those.

Mr. **Haddad**. That is going to happen. That is going to be what is going to happen. Here are some entrepreneurs. We pulled the deal together and they are in big trouble because of benefits. They cannot make the benefits. They cannot bring them to realization in terms of high dollars. As a result of that they are constricted from further expansion of their business. What is happening is the big companies are moving in and taking over the deals.

I think we ought to distinguish between manufacturing. I think we ought to be careful not to say that a proprietorship that is a mom-and-pop grocery store versus a small light assembly plant or metal shop where there is $2 or $3 million in business are the same. It is a different business. You have a different result in terms of capital expenditures.

The new law permits a $25,000 writeoff. I think it comes in to play ultimately by 1985 for first purchase of your assets under ACRS. That is very good for the little business that is that much over by 2 or 3 or 4 years. It is not at all significant for the manufacturing company that has to go out and spend $200,000 or $400,000 for a piece of equipment.

That is still a small business, but the difference is significant. That person has to be able to take advantage of the benefits of ACRS. We ought to be sure if we can in the questions that we distinguish between types of business.

Small is not defined. The SEC has not been able to define it. The IRS has not defined it. Nobody has been able to define it. We cannot define it in our own organization.

Certainly 9 people versus 109 people is a different type of business. We ought to recognize that when we analyze these statistics.

Senator D'AMATO. Senator Nunn?

Senator NUNN. I would like to thank all the panelists for being here. We appreciate your contribution.

Senator D'AMATO. Thank you, Senator Nunn, and I also would like to thank the panelists.

[The prepared statements of Mr. McCarthy, Mr. Haddad, and Mr. Fitch follow:]

STATEMENT OF JAMES D. McCARTHY ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION BEFORE THE SENATE COMMITTEE ON SMALL BUSINESS HOLDING HEARINGS ON SAFE HARBOR LEASING: USABILITY BY SMALL BUSINESS

MARCH 2, 1982

Good Morning. My name is James D. McCarthy. I am Vice President of General Business Services, Inc., Rockville, MD. I am appearing here today in behalf of the National Small Business Association (NSB), a multi-industry trade association founded in 1937 which has grown to include about 50,000 small businesses nationwide.

INTRODUCTION

The National Small Business Association believes that Congress clearly intended small and closely-held companies to participate in the safe harbor leasing provisions of the Economic Recovery Tax Act. However, we can report to this Subcommittee that the 'at-risk' rules make such transactions economically impractical. Therefore, unless there are changes in the law, a significant group of taxpayers will be excluded from participating in a program intended to stimulate the economy.

We were among the earliest of the small business groups to express disappointment about this exclusion. Other small business associations share this view.

Accordingly, we urge that, as a minimum, the Safe Harbor Leasing Provisions be immediately reconsidered by the Treasury Department and that the Congress proceed with dispatch to enact the changes Treasury does not believe it can make in order to give small business a fair opportunity to participate in these transactions as they are and will be structured.

At a January 22, 1982 meeting called by the Senate Small Business Committee Financial and Tax Analyst to discuss an agenda for 1982, safe harbor leasing was the major topic. One national association stated that approximately $30 billion involved in leasing could be better deployed elsewhere to serve the interest of small business.*

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*The Congressional Joint Tax Committee revenue estimates were $32.8 billion for calendar years 1981-86. See "General Explanation of the Economic Recovery Tax Act of 1981", Joint Tax Committee, December 29, 1981. Table V-4, footnote 5, page 401.

As you are well aware, Chairman of the Senate Finance Committee, Sen. Dole, has now expressed his intention to modify these provisions. (Press Release of Feb. 19, 1982).

IMPACT OF THE STATUTE

A review of the legislation from the small business viewpoint suggests the Treasury Department's imposition of the full at-risk provisions of Section 465 is not required by the Statute.

We see three reasons:

1. The intent of Safe Harbor Leasing is to facilitate transfer of tax incidents created by the Accelerated Cost Recovery System (ACRS), and the statute should be construed and interpreted to respect this Congressional intent;
2. The Statute and the Conference Report contain specific limitations to prevent abuse which are meant to and should control the general provisions of section 465; and
3. A contrary interpretation leads to an inequitable result -- exclusion of a class of taxpayers, i.e., small and closely-held firms, from the benefits of the law.

The safe harbor lease provisions are found in Section 201, the basic depreciation provision of the Economic Recovery Tax Act of 1981 and in Public Law 97-34 (95 Statutes at large) at pages 214-217.

This section adds a new Section 168 to the Internal Revenue Code, and simply stated, subsection 168(f)(8)A allows deductions and credits arising under the new ACRS to be transferred by lease if the parties so elect.

Subsection 8(B) sets up the following requirements for qualification as purchaser-lessors:

i. they must be corporations other than Subchapter S or personal holding companies defined in IRC section 542(a);

ii. there must be a minimum investment of 10% of the property's adjusted basis; and

iii. the lease term must be greater than 90% of the property's useful life or 150% of the class life.

In subsection (E) at page 47 of the Conference version of the legislation it is explained that: "the term 'minimum investment' means amount the lessor has at-risk with respect to the property (other than financing from the lessee or a related party of the lessee.)"

The significance of the section 542 test is believed to be two-fold. The rationale of imposing an additional personal holding company tax is based on two factors -- (1) a small number of individuals sheltering income in a corporation from the personal income tax rates; and (2) type of income that is involved, e.g., passive or non-operating income.

When the leasing provision first surfaced in the Senate, both the bill and the report explicitly applied section 465 (a)(1)(B) and (C) in erecting the definition of a qualified lessor. (See HJ Res. 266. page 71 and Senate Report 97-144, page 62.)

The final adoption by Congress of the section 542 test -- embracing objectionable passive income -- is a substantial indication of Congressional preference for a more specific, and therefore less preclusive, standard.

Later in the statute, in section 211(f)(1)(8)(B) (page 61 of the Conference version) the statute specifically applies a specific set of modified at-risk rules to the investment credit. After referring to section 465(b) of the Code, the section goes on to provide that a taxpayer who is at-risk for "an amount equal to 20% of the basis...of property...shall for the purposes of this paragraph be considered at-risk with respect to any amount borrowed in connection with the property..." (as long as there is a qualified lender.)

REGULATIONS

In drafting the implementing regulations, particularly as to small business, it is possible to argue that the Treasury Department had several choices short of giving full and immediate effect to the at-risk rules of section 465.

The first alternative would have been to cite specific requirement for lessors under section 201 and for the investment credit under section 211 as specific standards superseding the general provisions of section 465. This construction is consistent with the purpose of the statute -- to facilitate the transfer of benefits created by the new ACRS system.

Subsection 8(B), the lessor limitation of section 201, excludes only two types of small businesses --those which have elected to do business as Subchapter S corporations; and those companies which are both closely-held (50% owned by 5 or less shareholders) and have the requisite 60% of passive income.

This construction is strengthened by the Congressional agreement in Conference regarding the scope of the regulatory authority conferred upon the Treasury Department. The Conference Agreement states: "the conferees intend that the amount and timing of cost recovery allowances in the hands of the lessor would have been the same as they would have been in the hands of the lessee." (Item #22).

This is consistent with the statutory scheme that the lessor should not be able to take advantage of any greater deductions and/or credits than originally were available to the lessee. But this language can be read as intent that the transfer not involve any less benefits either.

A second alternative available to Treasury was the adoption of a clarifying procedure. In fact, such additional efforts were undertaken in the area of strip leases, leases involving possible bankruptcy, and also consolidated returns, as to which portions of the regulations were "reserved".

However, the course Treasury adopted was to promulgate the following rule as a part of the October 20th regulations:

> "(f) at-risk requirements. The amount of investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at-risk rules under the investment tax credit provisions and section 465 apply to the lessee or the lessor."

Later in the regulations, subsection (f)(8) - 4(b) explicitly provides that if the seller-lessee is bound by the at-risk rules, then the purchaser-lessor will be equally bound, even if the lessor is a large company and that would presumably be free of the lessor restrictions contained in section 201.

IMPACT ON SMALL BUSINESS

These regulations restricted the participation of small businesses in several ways.

The first impression given to the business community was that participation as lessees for closely-held companies was foreclosed unless they are totally at-risk with respect to the acquisition of the equipment concerned. Subsequent inquiries have not yet resolved the question of whether initial financing is the determinative or the only test.

Because of this, smaller firms were effectively denied the operation of leasing for that period prior to November 13, 1981 when pre-acquired 1981 equipment could qualify for leasing. While it was possible to have small firms refinance on a recourse basis simultaneous with closing on a lease transaction, the necessity for doing so cast an additional cloud over the opportunities for smaller firms.

Then, as to property acquired subsequent to October 20, when the at-risk requirements were clear, another question arose as to a correct procedure where a firm would make a 20% down payment and borrow the remainder from a qualified independent lender.

The problem was whether the amounts the lessees received pursuant to the lease would be used by the Treausury Department/IRS to reduce the amounts which were originally at-risk.

There has been continuing uncertainty as to this point, caused by the absence of explanation by Treasury. This lack of certainty has effectively stopped transactions affecting the sale of tax benefits by closely-held companies.

On the other side of the transaction, closely-held corporations have been barred as purchaser-lessors by the requirements of section 465, which extend beyond the 10% investment minimum required under the ACRS provisions and the 20% required by the investment credit provisions, to impose a burden of total at-risk financing to qualify for the full investment credit and deductions.

It is readily understandable that such a commitment is more difficult and costly for a closely-held lessee than for publicly-held corporations.

However, even for public companies the at-risk as a lessor, of being held to the limitations of a closely-held lessee under the regulations, has constituted a pervasive disincentive for larger corporations to seek the purchase of ACRS benefits from smaller enterprises.

One recent article reported a lease covering assets of $165,000 and noted that Maryland National Leasing Corporation was "getting a tremendous amount of interest from the smaller companies that weren't being solicited by the investment bankers." ("Firm Claims Record as Broker of Tax Breaks through Leases," by Jake Newman, Washington Post, Washington Business, February 8, 1982, page 5). But it is difficult to envision how any closely-held firm could qualify for one of the smaller transactions under the current regulations.

Indeed, the Wall Street Journal Small Business Column of the same day stated:

> "Small Businesses don't get anywhere near the tax benefits big companies receive from the safe harbor leasing provisions..."

("Leasing Breaks Limited for Small Firms", by Sanford Jacobs, Wall Street Journal, February 8, 1982, page 29:1).

It can thus be concluded that small businesses have been and remain virtually shut out of both sides of safe harbor leasing transactions.

Such an exclusion would appear to be both discriminatory and inconsistent with the intent of the ACRS and safe harbor leasing provisions.

Thank you for the opportunity to express our views on this section of the Tax Code.

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STATEMENT OF
ROBERT L. HADDAD, CPA

SAFE HARBOR LEASING

INTRODUCTORY REMARKS

Mr. Chairman and Members of the Committee:

My name is Robert Haddad and I want to thank you for the opportunity to appear before you today. I am a senior manager with Price Waterhouse and head up our firm's Small Business Tax Practice in Boston. I am speaking to you today on behalf of SBANE, a small business organization which represents a regional coalition of businesspersons and their concerns.

CONGRESSIONAL INTENT OF LEASING PROVISIONS

I would like to address my comments toward the issue of Safe Harbor Leasing as enacted by the "Economic Recovery Tax Act of 1981" (the Act), and specifically, how these incentives impact small business. It is axiomatic that leasing rules are an essential part of President Reagan's tax program to encourage economic growth. "Safe harbor leasing" was enacted as a means of assuring that the investment stimulus of accelerated cost recovery and investment tax credit would be made available equally to all eligible parties making new investments, whether or not the investing party has significant current income.

Secretary of the Treasury Regan, himself, in a November 29, 1981 interview with David Brinkley on the ABC news program "This Week", said that the original design of safe harbor leasing was to help companies in formation with no income against which to offset tax credits. The Secretary further stated that by allowing the benefits to be used currently (rather than be deferred) via a sale, the company receives cash flow, becomes more productive, invests more in capital formation, and so on.

We agree with the underlying premise that these leasing transactions will provide significant help to companies who may otherwise be unable to fully utilize the provisions of the Act. Our belief that safe harbor leasing embodies sound principles is evidenced by the following observations: the tax benefits are passed through to the firm actually making the investment; the total deductions and tax credits created remain unchanged in amount; and only economically profitable investment decisions will be made. Safe harbor leasing is important to insure that the incentives passed by Congress will be fully utilized by taxpayers. The Committee Reports, which I am certain you are familiar with, implicitly suggest that the financial leasing industry be deregulated by virtue of the elimination of certain tax rules and regulations.

TREASURY POSITION

Assistant Secretary of the Treasury, John Chapoton's oft-quoted October speech affirmed this intent when he said "Because ACRS and the increased investment tax credit create additional deductions and credits...leasing is even more important to make sure that the incentives Congress passed will be used." His closing comments are self-evident of the purpose for safe-harbor leasing:

> "What tax leasing guarantees is that the investment stimulus of ACRS will be available equally to all firms which make new investments, whether or not the particular firm has significant current income. The choice of investments made in the economy will be determined by the economic profitability of the investments, not by special tax benefits available only to certain firms with particular tax characteristics. Far from being a special interest benefit for distressed industries or cash rich companies, leasing is a tool for spreading the investment stimulus of the new tax law more equally throughout the economy. As I stated at the outset, safe harbor leasing, which allows more efficient leasing transactions than under prior law, is an essential ingredient of the new ACRS rules.

In his remarks, the Assistant Secretary also indicated that the seller of property in a transaction would not transfer any more credits or ACRS deductions than it otherwise would have been entitled to claim, taking into account the at-risk rules of Section 46(c)(8) and Section 465. On the other hand, a purchaser of tax benefits under a safe-harbor lease would not be limited by those rules from claiming the credits and deductions that would have been available to the lessee.

TECHNICAL ISSUE IN THE TEMPORARY REGULATIONS

The temporary regulations do not follow through. Rather, they limit the credits and deductions with respect to the leased property to the "extent the at risk rules under the investment tax credit provisions and Section 465 apply to the lessee or to the lessor." In determining the amount the lessee would be at risk, the at-risk rules are applied as if the lessee had not elected to have Section 168(f)(8) apply. Thus, if the lessee would be treated as owner of the property but for federal tax law purposes, the lessee is treated as owner for purposes of determining whether an at-risk limitation applies. At the same time, the lessor under the safe-harbor lease is also treated as owner for purposes of applying the at-risk limitations to it. If the lessor and the lessee are both subject to the at-risk rules, the lessor is allowed only the lesser of the ACRS deductions and investment tax credits allowable to the lessor and the lessee. The effect of this rule is to restrict the use of safe-harbor leases by corporations which meet the stock ownership requirements of Section 542(a)(2) of the Code and thus are subject to Sections 465 and 46(c)(8) - but are not personal holding companies under Section 542(a), and thus not excluded from being qualified lessors under Section 168(f)(8)(B)(i)(I): in other words, closely held companies engaged in active trades or businesses.

DISCRIMINATION AGAINST SMALL BUSINESSES

This distinction between closely-held corporations and other corporations discriminates against the former by requiring that they maintain a significantly higher at-risk posture to qualify for a safe harbor lease. By virtue of the fact that the leasing rules have incorporated by reference from the at-risk provisions and investment-tax credit provisions rules which were designed to prevent abuse in the tax shelter area, small businesses are denied opportunities which occur from participating in safe-harbor leasing transactions.

The Treasury's rationale for their change is that the statute does not clearly substantiate their earlier position without an amendment to the safe harbor leasing rules. Therefore, we would like to suggest that an amendment be considered to remove this inequity for closely-held corporations and clarify the original Congressional intent.

DISQUALIFICATION OF LESSOR

Another burden to the small businessperson under the safe-harbor leasing rules is the harsh result incurred upon disqualification of a lessor. The Temporary Regulations at Section 5C.168(f)(8)-3(a)(2) interpret a "qualified lessor" to include a partnership all of whose partners are corporations other than electing small business corporation (Sub-S) or personal holding companies. This, in and of itself, we believe to benefit our consituency because it allows for small corporations to achieve synergism in a partnership where it would individually be lacking the capital to effectuate a leasing transaction. The Temporary Regulation goes on to state that if at any time during the lease term a partner ceases to be a corporation as discussed above, the entire partnership entity shall cease to qualify. We believe that this is unfair to the surviving partners, and that there should be a provision which allows for a substitute of the no longer qualified partner, or for the remaining partners to continue without terminating the partnership.

INDIVIDUAL AS LESSOR

A related issue of concern to the small businessperson is the exclusion of certain non-corporate taxpayers from the definition of "qualified lessor". Why should a sole proprietorship be denied the advantages obtainable by a corporation? We believe that an individual carrying on a bona fide business should have parity with his corporate competitor in regard to leasing. An individual proprietor who, for example, satisfies the standard under the research and development provisions in the Internal Revenue Code of "carrying on a trade or business" is obviously not going to be in a lease transaction for pure tax-avoidance purposes. We bring this matter to your attention in the hope that you will consider some way of allowing all small businesspersons to share equally in the benefits of safe harbor leasing.

EXAMPLE

I would like to refer you to an example of the economics involved in the basic sale/leasehold transaction. As you can see, the benefit of a safe-harbor leasing election to the seller will outweigh the advantage of retaining the investment tax credit and ACRS deductions.

This is evidenced by comparing the present value of the after tax cash flows under both scenarios as shown on Chart I, attached. Owing to the receipt of cash at an earlier point in time as a down payment for the tax sale in exchange for tax benefits, the seller realizes an economic advantage. Obviously the extent of this advantage is also impacted by the timing of other cash flows and the discount rate assumptions. This is especially important to smaller companies in the early steps of development because it provides an infusion of needed capital.

AVAILABILITY IN THE MARKETPLACE

A colleague on our Tax Committee, Mr. G. Stuart Baird, Jr., has surveyed a variety of people and organizations close to the leasing issue in order to determine the availability of SHL's to smaller businesses. Mr. Baird is especially suited for this task in that he is the President of a small lease counseling and brokerage firm. Please allow me to summarize the concensus of opinion relayed to Mr. Baird on this topic.

Let us assume you accomplish SBANE's recommended modifications, as detailed by various testimony given to the Congress on behalf of small businesses. What, then, is in store for smaller businesses?

Our discussions since October, 1981 with numerous tax accountants, smaller businessmen, established "economic" lessors, and potential tax-benefit-transfer (TBT) buyer/lessors confirmed the following as reasons why smaller-company interest and participation in such business has been negligible to date:

1. Most smaller businesses are closely-held and thereby perceived as less attractive to TBT lessors.
2. Complex, incomplete Treasury Regulations, which already counter Congressional intent, create uncertainty, as do unresolved State Tax and financial accounting issues.
3. Confusion still exists over the effects of the at-risk provisions, particularly on lessors which do business with closely-held lessees.
4. Huge publicly-reported transactions produced an "I'm too small" feeling and lack of an active market, as well as concern over cost/benefit of SHL.

5. Capital equipment acquisitions have been reduced due to poor business prospects and the high cost of money.
6. Knowledgeable intermediaries, particularly economic lessors, are reluctant to do or arrange brokerage of SHLs due to such uncertainties.

The July legislative changes in SHL provisions without hearings and incomplete, inaccurate media coverage resulted in a negative public response. Consider the effect on SHL's if they are characterized as revenue "losses" rather than deferrals - "tax avoidance" rather than additional business investment or debt reduction. The recognition that SHL proceeds sustain jobs and help U.S. taxpayers by increasing available cash is overshadowed by feelings of anger and guilt, even among TBT buyers!

Yet without these impediments, most people interviewed feel there is significant latent demand. SHL will appeal to smaller businesses, which will increase the supply and availability of such service. The President of a large bank lessor which had only done multi-million dollar SHL's initially as a broker, then for its own account, "finds the business increasingly attractive granted the recommended changes are made." He would gladly pool and sell $100,000K leases, whereas as he currently feels that a single $100,000 deal is too small. (Such a professional lessor adds substance and accountability by providing 100% financing - even if borrowed from the lessee, plus systematized, audited reporting. Tighter credit evaluation would reduce SHL's risk, hence government revenue deferral.) Requiring management of TBT through a professional lessor would permit reporting of less burdensome detail, e.g., question #3, IRS Form 6793 - "a description of each individual property..." The Vice-President of a large New England bank told me a few days ago that even though the transition costs of a SHL deal appear high, they are much better than the terms available to a small business under a straight purchase where interest rates are several points over the prime rate. The real benefit of a SHL transaction is that the effective cost of obtaining the equipment is decreased to the lessee/user because of his improved cash inflow.

$100K now is the minimum size for another large economic lessor which has advertised nationally and reports a $300K average to date. "Until others develop and advertise interest in smaller leases, SHL cannot be fairly judged".

The American Association of Equipment Lessors' January News Bulletin reports that marketing is the greatest uncertainty. "Several (economic) leasing companies are developing new lease products for SHL treatment. They focus on smaller sized leases, because the area is relatively free of TBT competition and one in which lessors are more willing to give nominal purchase options".

What about under $100K? Manufacturers and distributors of equipment already lease more of the smallest items because they are situated to provide this service most economically. They regularly visit customers, process documents, and service equipment. For example, Mack Truck advertises rentals at under 8% equivalent interest. This is how benefits are most likely to reach the smallest lessees, rather than through a cash payment. But few yet understand and use leasing well, whether self or third-party financed. Creating the incentive of clear equality on a tax basis with other lessors will stimulate attractive offerings to smaller businesspersons.

As actual Treasury-collected TBT figures through December are released, bear in mind the expensive handicaps under which everyone has had to function and the cost reductions which you can facilitate by influencing SHL provisions as suggested in our SBANE testimony.

CHART I(1)

COMPARISON OF SELLER POSITION RETAIN VS. SAFE HARBOR SLB

	Sale of ACRS and ITC Benefits (After-Tax Cash Flow)	Retain ACRS and ITC Benefits (After-Tax Cash Flow)
1981	360,000	0
1982	0	0
1983	0	0
1984	0	0
1985	597,670	1,120,000
1986	156,730	0
	1,114,400	1,120,000
P.V. at 15%	780,785	640,363
P.V. at 9%	886,685	793,436

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(1) Hahn, "Transferring Deductions and Credits Under The Economic Recovery Tax Act of 1981 - The Special Rule For Leases", TAXES, December, 1981.

CHART II

SELLER AFTER-TAX CASH FLOW

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
		Debt Service Received						
	Cash Received	Interest Income	Principal	Rent Payment (2+3)	Net Tax Deduction (4-2)	Unutilized Deductions (Cumulative)	After-Tax Benefit of Utilization of Deductions	Total After-Tax Cash Flow (1+7)
1981	360,000	69,700	53,660	(123,360)	53,660	53,660	0	360,000
1982	0	255,004	238,438	(493,442)	238,438	292,098	0	0
1983	0	211,812	281,630	(493,442)	281,630	573,728	0	0
1984	0	160,794	332,648	(493,442)	332,648	906,376	0	0
1985	0	100,536	392,906	(493,442)	392,906	0	597,670*	597,670
1986	0	29,362	340,718	(370,080)	340,718	0	156,730	156,730
	360,000	827,208	1,640,000	(2,467,208)	1,640,000		754,400	1,114,400

*46% of cumulative unutilized deductions plus 1985 deduction.

CHART III[1]

BUYER AFTER-TAX CASH FLOW

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
						Debt Service Paid				
	Initial Payment	ACRS Allowances	After-Tax Allowances (46% of 2)	Investment Tax Credit	Rental Received	Interest Expense	Principal	Taxable Net Income	Taxes Owing (46% of 8)	After-Tax Cash Flow (1+3+4+9)
1981	(360,000)	300,000	138,000	200,000	123,360	(69,700)	(53,660)	53,660	(24,684)	(46,684)
1982	0	440,000	202,400		493,442	(255,004)	(238,438)	238,438	(109,682)	92,718
1983	0	420,000	193,200		493,442	(211,812)	(281,630)	281,630	(129,550)	63,650
1984	0	420,000	193,200		493,442	(160,794)	(332,648)	332,648	(153,018)	40,182
1985	0	420,000	193,200		493,442	(100,536)	(392,906)	392,906	(180,736)	12,464
1986	0	0	0		370,080	(29,362)	(340,718)	340,718	(156,730)	(156,730)
	(360,000)	2,000,000	920,000	200,000	2,467,208	(827,208)	(1,640,000)	1,640,000	(754,400)	5,600

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[1] Hahn, "Transferring Deductions and Credits Under The Economic Recovery Tax Act of 1981 - The Special Rule For Leases", TAXES, December, 1981.

PREPARED STATEMENT OF JOHN H. FITCH, JR.,

SUMMARY

On behalf of the National Association of Wholesaler-Distributors' 121 member national associations and their aggregate 45,000 member companies, we strongly support the leasing provision of the Economic Recovery Tax Act and its potential cash flow benefits for wholesaler-distributors who suffer most the erosion of operating and growth capital from high interest rates and inflation.

However, as interpreted by the Treasury Department through its October 20, 1981, temporary regulations, closely-held wholesaler-distributors are limited (as lessors) by the "at risk" rule of Section 465 of the Internal Revenue Code.

This application, in NAW's view, is administrative in origin and was a conscious decision by the Treasury Department to limit leasing to larger companies.

We believe the Treasury Department can administratively reverse that restriction rather than requiring a legislative resolution as Treasury advocates is necessary.

NAW advocates the following solutions to the problem:

(1) that Treasury Department administratively remove the application of the Section 465 "at risk" rules to closely-held lessors by amending Temporary Regulation Section 5c.168(f)(8)-7(f); or

(2) that Treasury Department publicly support a statutory amendment to Section 168(f)(8) exempting the application of the Section 465 "at risk" rules to closely-held lessors; or

(3) provide a technical amendment to the Technical Corrections Act to exempt closely-held lessors from the application of the Section 465 "at risk" rules.

Failure to correct this problem will result in the following:

(1) continued denial to affected wholesaler-distributors of an affordable, marketplace capital formation mechanism to counter the ravages of high interest rates and inflation and to keep them productive and, in many cases, in business could result in significant negative economic consequences; and

(2) causal reduction in the pool of buyer/lessors for small business seller/lessee, rendering the usefulness of safe-harbor leasing for small business at a minimum.

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

The National Association of Wholesaler-Distributors is a federation of 121 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business (see attached list).

The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

THE INDUSTRY

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely-held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U. S. economy.

A 1981 profile of the wholesale trade, as compiled by the U. S. Department of Commerce from Census Bureau figures, shows the following:

SIC CODES: 50-51

Sales (million $)	955,175
Employment (000)	5,280
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

BACKGROUND

In his testimony before the House Appropriations Committee on February 9th, Secretary Regan stated that small and new businesses will benefit from the safe-harbor leasing provisions of Economic Recovery Tax Act of 1981 and that this circumstance was intended. He indicated small and new businesses which generally cannot use tax credits because thay have negligible earnings can, in fact, use leasing as a means to obtain needed cash flow.

However, the application of the "at risk" provisions to leasing transactions effectively precludes many small and medium-sized operating corporations from full utilization of these provisions.

As amended by the Economic Recovery Tax Act of 1981, Section 168(f)(8)(B)(i) of the Internal Revenue Code states that in order to be a lessor under the safe-harbor leasing provisions, a lessor must be:

(1) a corporation, other than a Subchapter S corporation or a personal holding company;

(2) a partnership, all the partners of which are qualifying corporations; or

(3) a grantor trust, the grantor and all of the beneficiaries of which are either qualified corporations or qualified partnerships.

The lessee, however, may be any of the above, including a subchapter S corporation partnership or individual holding company. The stated purpose of the statute is to provide a cash flow mechanism by which a lessee company in a loss position can receive present value for tax benefits received under ACRS but which are unusable by him in the current year.

Moreover, it provides tax relief for marginal companies who also need a cash flow boost.

With high interests rates and inflation eroding the profits wholesaler-distributors use for operations, growth and payroll, leasing provides a valuable marketplace capital formation mechanism to keep these companies productive and, in many cases, in business.

There is no question that safe-harbor leasing overrides the fundamental principles of tax law which look to the substance rather than the form to determine the real nature of the transaction (for tax purposes).

However, Congress and the Administration have made a conscious decision in this instance that the immediate cash flow needs of marginal or loss companies who are placed in that condition by high interest rates and inflation rather than poor management are more important than traditional tax law principles. Moreover, it is a marketplace fix rather than a government fix. The disruption of the economy in terms of employment, distribution channels, and productivity should these companies fail would be significant.

Moreover, the vulnerability of these small businesses to mergers and acquisitions would significantly increase as the tax benefits of ACRS began to accumulate over time. This would lead to further concentration based on tax decisions rather than competitive reasons; bad public policy to say the least.

Under Temporary Regulation Section 5c.168(f)(8)-7(f), issued by the Treasury Department on October 20, 1981, the amount of investment tax credit and ACRS deductions allowed to a lessor with respect to leased property is limited to the extent the "at-risk" rules under the investment tax credit provisions and Section 465 apply to the lessee or lessor.

Section 465 applies to corporations which have more than 50% of the value of their outstanding stock owned, directly or indirectly, by not more than five individuals. Thus, under the regulations, these companies would not be able to "buy" property (i.e., unused ITCs and ACRS deductions) in a sale/lease-back transaction financed by nonrecourse indebtedness because they would not be considered "at risk" to the extent of such amounts.

While the Act authorizes the Secretary of Treasury to prescribe regulations necessary to carry out the purposes of the safe-harbor leasing provisions, including limits on the amounts and timing of deductions, it does not specifically apply the Section 465 "at-risk" rules to leasing.

The practical effect of that one provision of the regulations is to arbitrarily exclude a major segment of the business community from the benefits of safe-harbor leasing -- namely, small business -- which needs it the most.

It is a fact that small business is extremely dependent on debt financing as opposed to equity financing for its operating and growth capital. Thus, high interest rates over a sustained period of time have a disastrous effect on these companies.

They are immediately thrown into a marginal or loss position by external forces not of their making.

Safe-harbor leasing is designed to assist these businesses. But the Treasury regulations effectively take it away.

By applying the 465 at-risk rules to nominal lessors, Treasury has eliminated the number of buyers available for small business lessees. This further reduces their ability to utilize safe-harbor leasing as a means of obtaining affordable capital.

As a general rule, small business lessors are the most likely "buyers" for small business lessee tax benefits. Therefore, by arbitrarily reducing that buyer pool, the sellers have less opportunity to utilize the safe-harbor leasing provisions.

The application of the 465 at-risk rules by Treasury to nominal lessors was discretionary and makes no practical sense so long as the lessor is an operating corporation and can buy through a 168(f)(8) transfer only those credits and depreciation allowances available to the lessee.

TREASURY POSITION

To say that the Treasury Department has been inconsistent with regard to its position on this issue is an understatement.

In a speech before the Tax Society of New York University on October 5, 1981, Assistant Secretary for Tax Policy John Chapoton stated:

> ". . . a purchaser of tax benefits under a safe-harbor lease *will not be limited by the "at risk" rules* from claiming the credits and deductions that would have been available to the lessee." (emphasis added)

Mr. Chapoton went on to say:

> "What tax leasing guarantees is that the investment stimulus of ACRS will be available *equally* to all firms which make new investments . . . " (emphasis added)
>
> "Far from being a special interest benefit for distressed industries or cash rich companies, leasing is a tool for spreading the investment stimulus of the new tax law *more equally* throughout the economy." (emphasis added)

On December 16, 1981, Dennis Thomas, Assistant Secretary for Legislative Affairs at Treasury, wrote the following to Senator Nunn (D-GA), ranking minority member of the Senate Small Business Committee:

> "Although the leasing rules generally do not expressly preclude (small companies) from engaging in leasing transactions, the *regulations* do provide that the at risk rules apply in determining the amount of deductions and credits a lessor may deduct." (emphasis added)

NAW POSITION

NAW strongly supports the elimination of the application of the Section 465 "at-risk rules" to lessors under the safe-harbor leasing provisions.

The bias against closely-held corporations is neither justified nor supportable by the facts. It arbitrarily precludes an important segment of the business community from utilizing the safe-harbor leasing provisions. These firms are also the ones most affected by the cash flow erosion of inflation and high interest rates.

Elimination of the ability of closely-held corporations to use the safe-harbor leasing provisions also alienates a significant segment of the business community (with tremendous grass roots strength) from the leasing support base. Moreover, it gives credence to the notion that leasing is for big business only.

The application of the Section 465 "at-risk" rules to lessors makes closely-held corporations less desirable as potential lessees because potential buyer/lessors who are not bound by the Section 465 rules would, nonetheless, be limited by them via their application to the lessee.

Moreover, it would unnecessarily limit the pool of buyers for small business tax benefit sellers.

Finally, NAW, senior tax staff of Finance Committee members, and other knowledgeable leasing tax specialists agree with the premise that Treasury could administratively eliminate the problem by amending its temporary regulations. We are not convinced, as is the Treasury staff, that legislative resolution is necessary.

As you well know, the leasing provision is extremely vulnerable politically; therefore, early resolution of the problem is essential if small, closely-held corporations are to benefit from safe-harbor leasing and, consequently, support its retention.

RECOMMENDATIONS

(1) That the Treasury Department amend its October 20, 1981, Temporary Regulations to eliminate the application of Section 465 of the Internal Revenue Code to safe-harbor leasing; or

(2) that the Treasury Department publicly support legislation to eliminate the application of the Section 465 at-risk

rules to safe-harbor leasing if an administrative solution is not forthcoming; or,

(3) that the Treasury Department initiate or support a technical amendment to the Economic Recovery Tax Act Technical Corrections Act that would eliminate the application of Section 465 of the Internal Revenue Code to safe-harbor leasing.

Mr. Chairman, that concludes my statement. I would be happy now to respond to any questions you or members of the Subcommittee might have.

National Association of Wholesaler-Distributors
NAW
The national voice of wholesale distribution

IMPACT OF "AT RISK" RULES ON SAFE HARBOR LEASING

DATA

Machine Cost = $100,000
10% Investment Tax Credit = $ 10,000
First Year ACRS Depreciation = $ 30,000
Cost Recovery Period = 5 years

SAFE HARBOR LEASING
(without at-risk application)

Wholesaler-Distributor A = Seller/Lessee **Wholesaler-Distributor B = Buyer/Lessor**

$10,000 ITC → unusable by A → applied against taxable income
$30,000 Depreciation

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced tax income by $40,000

* * * * *

SAFE HARBOR LEASING
(with at-risk application)

Wholesaler-Distributor A = Seller/Lessee **Wholesaler-Distributor B = Buyer/Lessor**

$ 1,000 ITC
$ 3,000 Depreciation → unusable by A → applied against taxable income

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced taxable income by $4,000

* * * * *

SAFE HARBOR LEASING
(with at-risk applied to lessor)

Wholesaler-Distributor A = Seller/Lessee **Wholesaler-Distributor B = Buyer/Lessor**

$10,000 ITC → unusable by A → $4,000 applied to taxable income
$30,000

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced taxable income by $4,000

* * * * *

National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Coated Abrasives Fabricators Association
Cooperative Food Distributors of America
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
  American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Hobby Industry Association of America

Independent Medical Distributors Association
The Irrigation Association
Institutional & Service Textile Distributors
  Association, Inc.
International Ceramic Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors

National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Spring Service Association
Steel Service Center Institute

Textile Care Allied Trades Association
Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Distributors Association
Warehouse Distributors Association for
  Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
1725 K Street, N.W., Washington, D.C. 20006 202/872-0885

Senator D'AMATO. We now call our third panel: Mr. Milton Harris, president of the Maryland National Leasing Corp.; Mr. Paul Finfer, Beneficial Leasing Group, New York; and John Mullenholz, National Farm and Power Equipment Dealers Association, Washington, D.C.

Mr. Harris?

STATEMENT OF MILTON HARRIS, PRESIDENT, MARYLAND NATIONAL LEASING CORP., TOWSON, MD.

Mr. HARRIS. Thank you for having me here, Senator.

I have submitted a written paper a few days ago. If you have read it, I will just skip over that and save your time.

Senator D'AMATO. If there is anything you feel you would like to emphasize, any point whether it is in there or out of there that you think is appropriate——

Mr. HARRIS. There is a point that has come up this afternoon that I thought I ought to perhaps comment on.

I think we have to make sure everybody understands is that we are talking about two different types of transactions. One of them is known as a tax benefit transfer. That in effect is the buying and selling of tax benefits, pure and simple.

In such a case, when somebody acquires equipment, they go elsewhere for the rest of the financing.

In the other type, safe harbor leasing, the effect is not a whole lot different than the leases that are being written today and have been written for years. There is 100 percent financing. A lower rate is given to the lessee because he is giving up his tax benefit.

The main changes in section 168F8 are that at the end of the lease you can set a purchase price which you now cannot do and which many users of equipment find somewhat hard to bear. They are afraid that runaway inflation is going to cause them to pay for the same equipment twice. You hear that phrase often.

This particular part of the new act I think can be deemed to help some people, if not all.

The other main change that I see is that we can now talk about special purpose equipment being leased. In the past, it had to be known as general purpose. This precluded certain types of equipment or brought you into a grey area. It certainly did not aid in using leasing as a financing technique.

There are some other differences which I will not bother getting into.

I would also like to make a couple of other points if I may. I understand that as a matter of fact some small safe harbor leases are now being batched like vendor programs where a company will be handling very small amounts. The proliferation to smaller companies may be taking place. We have not heard about it yet. It has not gotten a whole lot of publicity, but I suspect that the market will find a way to do it.

A point I think I made in the paper and one which I cannot emphasize too much, is the main problem small businesses find in utilizing this act as a source of financing is the way the Treasury regulations are written.

If such companies have credit problems, the lessor is in a position to suffer a very substantial loss. In my opinion, and I have talked to a number of other people who I think would agree with me, the main reason that small business has not benefited as much from this act as it might—you notice in my statement that we rejected out of hand some 40 or 50 transactions—is that if we as a lessor lease to a small company and they go into bankruptcy, we are very uncertain as to what is going to happen. We suspect that we could have all kinds of problems and lose much of the benefit. It is just a risk that is unacceptable. This is the real problem and it is easily corrected.

All you need to do in my opinion is to say that bankruptcy is not a disposition of the equipment and perhaps some other fine tuning.

Senator D'AMATO. Have you made that suggestion in your testimony?

Mr. HARRIS. Yes, I have, sir.

I also believe that leasing is the best way to accomplish the transfer of benefits, either as a sale of business or under full financing because I think the industry has the knowledge and the efficiency to do it.

We have found in a number of transactions that we have seen that they have been put together by people who are really unfamiliar with this business. They have either proven to be illegal, quite imaginative often, but obviously quite completely out of touch with what is going on in the law, or they have been uneconomic for one reason or another.

People come into us with homemade transactions. We tell them they cannot do that, that that is not what the law says. They say, "Well, we read it in the Wall Street Journal." They really do not have a 100-percent idea of what is going on.

In my experience and in our policy, it has been the policy of most leasing companies when they are talking to a prospective client, one that wants to finance equipment, to not peddle a particular project or approach, but to find out what that client wants. It is a very competitive business. In some instances you would advise one type of transaction. In some instances you would advise something completely different. This is one reason I think the industry left to itself will do a much better job as time goes on. The costs are going down. Uncertainty has been a very expensive proposition.

That is really about all I had to say. I do appreciate your having me here. If I can provide any background information at any time to your committee or staff, I would certainly be delighted to do it.

Senator D'AMATO. We are very appreciative.

Mr. Finfer?

STATEMENT OF PAUL M. FINFER, BENEFICIAL LEASING GROUP, NEW YORK, N.Y.

Mr. FINFER. Mr. Chairman, members of the committee, I am Paul Finfer, president of Beneficial Leasing Group, which is a diversified equipment lessor headquartered in New York.

Today, however, I am speaking on behalf of the American Association of Equipment Lessors, an association of over 800 member corporations that are actively engaged in equipment leasing, and the bulk of whose portfolios consist of equipment lease transactions entered into with small businesses.

The so-called safe harbor leasing provision of the Economic Recovery Tax Act of 1981 has in a very short period of time created substantial controversy and confusion both with respect to who it was intended to benefit and how it is being used.

One thing is clear, however. That is that because of the cumbersome and restrictive rules contained in the temporary regulations issued by the Treasury, safe harbor leasing is not being used to any meaningful degree by small business; and it will not be unless the regulations or safe harbor itself are substantially modified.

Today's equipment leasing industry began in this country after World War II. The GI's returned home from overseas, started new business ventures, and as the economy started growing again they began seeking additional ways to expand their manufacturing capabilities and to finance their growth.

Leasing provided a convenient and flexible way to accomplish this. While conventional financing of the day was based upon a 36-month loan with a down payment requirement of 25 to 35 percent, leasing provided 100 percent financing at fixed rates for a term up to 10 years. Almost anything could be leased.

In 1981, the equipment leasing industry financed approximately $40 billion worth of equipment. Small business leasing accounts for nearly one-half of the dollar volume and probably between 80 to 90 percent of the leasing transactions entered into by my association members.

In 1962 the investment tax credit became a part of the United States Internal Revenue Code and equipment leasing became more tax oriented. By the late 1970's competition had resulted in leveraged lessors having to pass through, in present value terms, 100 percent of the tax benefits to their lessees in the form of low rental payments in order to remain competitive.

In early 1981, as the impact of the then proposed accelerated cost recovery system and enhanced ITC provisions of the Economic Recovery Tax Act were studied by Congress and industry, it became apparent that many business entities, including some who needed assistance most, were incapable of efficiently utilizing these new capital investment incentives.

Many methods of dealing with this problem were proposed. Two gained the most favor: Refundable investment tax credit and leasing.

Refundable investment tax credit was costly. There was no mechanism or system in place to police it and to protect it from mass abuse.

Leasing on the other hand had a fine low cost policing system in place, which was the industry itself, but it was governed by archaic tax regulations which would hinder its efficiency under ACRS.

The answer was simple: Modernize the leasing rules so it could continue to play its historic role as an efficient and economically substantive financing source. The leasing industry proposed language adopted by the administration and the Treasury which dealt with the problem. That language was incorporated into the administration's bill.

The so-called six depressed industries continued to lobby very hard for refundability. The result was a very hastily written compromise which is now known as safe harbor, and which for all intents and purposes, addressed itself primarily to the problems and wishes of some major corporations. And to protect against some possible abuses by these major corporations, the Treasury issued 70 pages of cumbersome and restrictive regulations, the effects of which put small business at a competitive disadvantage under safe harbor.

Today, either of two types of leases are most usually written under safe harbor: Tax benefit transfers or TBT's, which are generally written with major corporate lessors, have no economic substance other than the sale of tax benefits; are not leases in the real or historic sense; and are the transactions most often cited as being abusive in the press—and economically substantive leasing, which is a conventional or historic lease transaction where there is a fixed or nominal purchase option price, and where safe harbor is invoked merely to protect the purchase option from IRS review.

Almost all small business use of safe harbor as seen to date by my association members, has been confined to this second area of leasing.

To summarize, as the Congress considers legislation to repeal or amend safe harbor, we urge it to consider that the abuses of safe harbor that have attracted so much attention and caused so much concern were actually TBT transactions.

As a practical matter these TBT transactions have not been significant for small business at all but only for large corporations. To some extent, small business has used safe harbor to enter into conventional leases with equipment lessors to acquire productive equipment at an efficient cost.

The AAEL recommends that Congress consider amendments to the safe harbor provision and/or the IRS regulations to continue to encourage small businesses and allow more efficient use of conventional economically substantive leasing within safe harbor.

Senator D'AMATO. Mr. Mullenholz?

STATEMENT OF JOHN MULLENHOLZ, ESQ., NATIONAL FARM AND POWER EQUIPMENT DEALERS ASSOCIATION, WASHINGTON, D.C., ACCOMPANIED BY THOMAS HUSET, PRESIDENT, ASSOCIATION CREDIT PLANS, INC.

Mr. MULLENHOLZ. Thank you, Mr. Chairman, and thank you for including us at the last moment on this panel. We appreciate that very much.

Senator D'AMATO. I want to commend Senator Nunn because he thought it was a very important area which we should include.

Senator NUNN. If you want to find out where the losses are in America, you have to go to the farming areas.

Mr. MULLENHOLZ. That is exactly right.

Senator, in order to make this a meaningful hearing, I have with me today Mr. Thomas Huset, the president of Association Credit. His organization is known as the farm plan. They are a service group that deals with banks, dealers, and the farmers. I think of all the people who could give you information in this area Mr. Huset can do it better than anyone else.

Very briefly, our organization represents all the dealers, the John Deere and International Harvester dealers, throughout the United States, some 10,000 of them. They are small businesses by any definition even though we do not have one.

Until recently we really have not seen a lot of activity or even heard much in Washington about leasing out in the field. The reasons are obvious, the costs of the legal and accounting services.

However, more importantly—Senator, I think you brought up the point—there is a real education process here because neither the banks, the dealers, or the farmers are aware of how to take advantage of this.

In addition to that, there are real psychological and emotional barriers to overcome. These people have been doing business one way since their fathers, grandfathers, and great-grandfathers started these organizations decades ago.

The result of safe harbor leasing programs, if they were applied to the farming industry, would be significant savings, particularly in the area of financing and the interest rates. It is one way they really have of combating high interest rates. Mr. Huset will address that specifically.

You are aware that the farm debt is $194 billion as of January 1, 1982, and about 40 percent of that is operations. For the last quarter of 1981 that operation debt was being financed at about 18 percent. It is projected at about 16.5 percent for this quarter of 1982. It is a very, very significant debt.

Mr. Huset flew in last night from Madison. We hastily put together a statement for your benefit. We would like the opportunity to answer questions you might have afterward and submit additional information.

You will find this gentleman to be a real wealth of information. He has undertaken the actual development of a program to permit the dealers and the farmers to take advantage of the safe harbor lease provisions. He was about to announce this when the chairman of the Finance Committee made his announcement first. Unfortunately, Mr. Huset is now in the doldrums wondering what to do at this point.

Senator NUNN. He is in the right room then.

Mr. MULLENHOLZ. I believe he is.

With that, let me turn it over to Mr. Huset.

Mr. HUSET. Thank you.

It is my pleasure to be here today. I have never done this before. I will state my positions and hopefully answer some of your questions.

I think it is important perhaps for me to relate a little bit more about the network that we currently have in place. All of it is involved in rural America. We go from the Big Timber, Mont., to Weslaco, Tex., to Wapakoneta, Ohio, and those are not towns that people hear about.

We are in 20 States. Our service is offered through some 500 rural banks. I might mention that they are strictly rural in nature. We do not function very effectively with an agribusiness financing system in major metropolitan areas.

We currently reach some 1,500 agribusinesses. Those 1,500 agribusinesses service 500,000 customers. In calendar year 1981 about one-quarter of a billion dollars was financed through our system known as the farm plan.

While we deal primarily in an open revolving type of credit which is unique in its character, the program is distinguished by a rather local flavor because of the involvement and the preserving of that valued relationship between dealer and customer and, in turn, their banker.

We had just recently undertaken trying to find a way to deliver Safe Harbor to this rather diverse network. At any point in time that we try to do something like this it is tremendously difficult because of the educational process. We have been through that with the system we currently offer.

As late as 1979--we have a study here that I will leave for you that was commissioned by the National Association of Farm Equipment Dealers in which they did a study indicating the future trends of analysis and an external evaluation for their dealers—only 6 percent of all farm equipment transactions were completed through leasing. This is just conventional leasing, not to say anything about the application of safe harbor.

Not only do they not understand the benefits available under this program, they did not really understand how to use leasing as a sales tool initially even though programs were offered through the major companies and through many leasing companies well qualified to extend them. However, to reach the marketplace and to educate it is a tremendously trying task.

We felt confident that given some of our inroads we could deliver a mechanism such as this to the grassroots level whereby the dealer would hopefully preserve a tremendously shrinking profit margin. The average farm equipment dealer in 1980 made something just a little over 2.5-percent profit on his sales. Many of those are down again this year. We felt we could preserve that profit margin while significantly reducing the end-purchase price to the farm consumer.

It was interesting to note—I think it was in Mr. Haddad's testimony—that he predicted an 18-percent effective financing rate down to 11 percent. That is exactly what our statistics show. In fact, as part of the testimony we are submitting we do have an analysis comparing conventional financing, a conventional leverage lease, and conventional direct financing leases that would indicate this direct cost reduction.

We are trying to do this on the basis of consolidating legal and accounting costs and delivering a consistent standardized package to the marketplace. That, in turn, took a considerable amount of organizational time.

We did feel it would prompt some sales in a sagging market. We would like to be able to extend it. However, at this point in time, as you are well aware, things are up in the air.

Thank you again for allowing me to speak my piece. If I can answer any questions, I would be more than happy to do so.

Senator D'Amato. I certainly appreciate your expertise. I was just commenting to Senator Nunn that in our State in New York our farming community is in deep, deep trouble for all those reasons, high interest rates, et cetera.

You heard Mr. Janeway talk about the fact that he did not think it would be doing too much to help them. I kind of think the difference between staying in business, and being competitive, and maybe having the kind of equipment that is necessary, and the inability to purchase that equipment at 18- and 19-percent interest rates and even higher is important.

Here you have an effective tool to bring those costs down to approximately 11 percent as you said and maybe even get a little capital infusion when this is done. Then maybe they can go out and buy the rest of the materials needed or hire someone where now they cannot. The family cannot be depended on either.

Let me ask Mr. Finfer a question. You talked about some of the abuses in terms of just the sale of the tax loss with no real leasing underlying. Is that correct?

Mr. FINFER. Yes, sir.

Senator D'AMATO. That is what you see as the major abuse. You called that TBT's?

Mr. FINFER. Yes; TBT's, tax benefit transfers.

Senator D'AMATO. I think that is the greatest difficulty I have had up here, trying to figure out all these acronyms.

The sale of those losses you see as really the greatest problem. Is that right?

Mr. FINFER. That is correct.

Senator D'AMATO. What about the small farmer? Could this system not be a tremendous aid and help to him? Do you not see benefits in safe harbor leasing for him that he would not be able to achieve in any other way?

Mr. FINFER. Let me distinguish the two because I think you raise an interesting point. This last year my company itself did about 20 million dollars' worth of farm equipment leasing, everything from irrigation equipment to egg-farming equipment to——

Senator D'AMATO. Was that in upstate New York?

Mr. FINFER. Some in upstate New York and as far west as California. We are pretty well all over the country.

I think the last gentleman brought up a very valid point in that one of the most difficult things with the farmers has been to educate them as to the benefits of leasing.

Let us distinguish the two because I think it really is important. Leasing has always served an historic function of passing on the tax benefits to a greater or lesser degree depending on the competition, to the ultimate user of the equipment in the form of lower rent. The lower rents create a better cash flow for the farmer or any lessee and make it easier for them to acquire the equipment.

The pure TBT, or tax benefit transfer is so designed by section 168 and in the regulations so that the farmer could very rarely qualify. We define the TBT as a transaction that is essentially a noneconomic wash sale with a lessee providing the debt. The farmer cannot get the debt, which is why he is coming here in the first place.

As Mr. Harris also pointed out, we look at safe harbor conceptually as the mechanism that Congress did want and the industry wanted in order to make leasing more efficient so it could continue to put up all the money, arrange for the farmer or whoever the lessee is, to finance the equipment 100 percent, and then to downgrade its rentals in terms of monthly rental payments so that the farmer would have a positive cash flow, as opposed to the TBT which just gives someone a shot in the arm up front the first year in terms of selling the tax benefits and has no value afterwards.

We are in favor of the safe harbor rules being allowed to remain in place on an economically substantive basis, but the regulations today, which were designed for TBT's, make that impossible.

Senator D'AMATO. Let us take that farmer who wants to go out and buy a piece of machinery that costs $100,000. Can safe harbor leasing make it more advantageous for him because he can now go to that potential lessor and get as much as 20 or 25 percent back so now he has $25,000 that he would not have had otherwise? Does not that effectively reduce what his payments are going to be quite substantially on that lease?

Would you be opposed to that?

Mr. FINFER. Not at all.

Senator D'AMATO. Why does not safe harbor help him then?

Mr. FINFER. As I said before, the concept of safe harbor does help him. It is the regulations that were designed for——

Senator D'AMATO. In terms of this as it sits right now where is he penalized other than that he cannot be the lessor? He is not the lessor. He is going to be the lessee.

Mr. FINFER. He is penalized two ways, again by virtue of what the regulations require.

Senator D'AMATO. What do they require?

Mr. FINFER. They require extraordinarily cumbersome filing requirements which have to be followed up not only by the lessor but by the lessee.

Senator D'AMATO. I have a friend over there who is going to set that up. He is going to set up a business that is going to deal with that.

Go ahead.

Mr. FINFER. It also prohibits the ability to batch those transactions in volume so that the costs of doing those transactions are amortized over a larger——

Senator D'AMATO. Batching or umbrellas are prohibited?

Mr. FINFER. Yes.

Senator D'AMATO. Under what section?

Mr. FINFER. The regulations specifically do not speak to the question of what we call warehousing, the ability of the lessor to accumulate a bunch of small leases and then sell them in a batch of 1 million or 5 million which would enable those transactional costs to be spread. They specifically exclude that.

Senator D'AMATO. They exclude that?

Mr. FINFER. Yes.

Senator D'AMATO. That would be a question then that we should ask of Treasury so that small business could have an opportunity to take advantage of this provision. That would be the umbrella, the packaging, the batching of these leases. We should ask whether or not they would be willing to support that kind of amendment.

Mr. FINFER. We, as an industry, have filed.

Senator **Nunn**. I agree. I think if we are going to continue this it is absolutely intolerable to have regulations that restrict it to large businesses.

Mr. **Finfer**. We as an industry wrote Treasury and specifically asked for that so we would have the ability to do that, but they just——

Senator **Nunn**. It is almost as if they purposely sat down and said, "How can we restrict this to simply big businesses?" Is that not right?

Mr. **Finfer**. I will tell you the truth. We were here and happened to have a meeting the day that the final language was submitted to Congress by the Treasury. We met with Treasury early in the day. One of our responses to the people at Treasury was that it appeared that 168(f)(8) was designed for large leveraged lease transactions and yet it did not speak specifically to that. Did it apply to everybody or did it not apply to everybody?

The response was, "What do you think it should apply to? We really have not given it that much thought because it was put together so quickly."

We asked for some time—to consider our response—and they gave us a few hours. We ran back to the association headquarters and polled about 30 members to find out what they thought. They said to try to make it apply to everybody so they could be competitive. We did.

Then the regulations came out and addressed large transactions.

Senator **D'Amato**. Mr. Harris, did you have something to comment on here?

Mr. **Harris**. To get into this question a little bit, we have looked into it. We are not in a farming area, but we have talked to some people who sell farm equipment and we have talked particularly to Farm Credit just north of Baltimore.

Bear in mind that that farmer under the present law, under ERTA, has two alternatives. The first alternative is to go to his local bank where he is known, borrow, say, 80 percent of the cost of that equipment and sell his tax benefits for the other 20 percent. This has two effects.

One effect is it gives him a downpayment which collateralizes his position and makes the bank feel better. Of course it also reduces his payments since he is financing a smaller amount even though he is paying the going rate. That is under a tax benefit transfer.

His other alternative is to obtain 100-percent financing at a lower rate, let us say 11 percent, from some intermediary. Let me tell you where the difficulties arise. Farm Credit is uniquely geared to local people doing the financing, although Mr. Finfer's organization does quite a bit on a national basis.

I think you would agree, Paul, that you are somewhat unique. You have developed an expertise, but there are a lot of major companies that do not feel comfortable with agriculture credits because in agriculture credits you do not just look at a balance sheet. You look at the individual man. You look at the value of his property and how he farms.

If I am sitting in Baltimore, I find this very difficult to do even in Pennsylvania much less some place like Colorado or Alabama. A lot of agriculture financing overall is done locally.

The local banks oftentimes are not geared to this, they are not familiar with all these new techniques, these new tax laws. They are not doing enough volume to make it feasible for them. If the farmer goes in and says, "Can I sell my tax benefit," the local banker probably does not know what he is talking about. If he does, because it is new, because he has not done it, he is fearful.

I guess what I am saying is that this goes back to the second point I tried to make before. If it were impossible to lose the tax benefits, in other words if that farmer went bankrupt, whoever bought those benefits could not lose them, I believe that the market will find a way to get the money to that farmer, or any other small businessman.

The problem is one of fear on the part of lenders or lessors that these small credits are difficult to analyze. You cannot spend $20,000 analyzing a $50,000 piece of equipment. You cannot get to know these small businessmen. You cannot get out and feel and touch and so forth. Therefore you walk away. You abdicate from this part of the business, not because you particularly want to but because it is uneconomical.

If the Treasury regulations were written so you could not lose those tax benefits, I believe—I do not have any experience to prove this—that the market historically has found a way to make use of tax benefits. There are a lot of companies that do not want to pay taxes. That is a very common thing. I think the market would find a way to do it.

However, it is difficult for small businessmen, particularly farmers. There is no question about that.

Senator D'AMATO. Senator Nunn?

Senator NUNN. I have learned a lot this morning. I congratulate all the witnesses. I do not have any particular questions that have not been covered, Mr. Chairman, and I know, like you, I am running about 45 minutes late for my meeting that started a long time ago.

I would just ask each of the witnesses to feel free to submit any further information for the record. I think this subject is going to be a pretty hot subject in the next 30 or 45 days.

I would like to make sure that this committee has a vivid understanding both of how this thing works and also what stake the small business community has in it and how we go about making the corrections if we are going to continue leasing at all.

Mr. MULLENHOLZ. Senator Nunn, from a political standpoint I do not see how this body can resist the pressure to do something in this area on safe harbor leasing.

Senator D'AMATO. It may collapse the whole thing.

Mr. MULLENHOLZ. Yes. The political pressure just seems overwhelming. Obviously the chairman of the Finance Committee has felt it. He has made statements to that effect.

To the extent that this committee could preserve some of these benefits for small business under whatever definition could possibly be arrived at, I think that would be the thrust at least of our organization and I think of many other people who have been before you here today. That might be a good area of compromise. I do not know.

Mr. **Harris**. I would like to make one more point. I think the main reason that people are concerned about the tax benefit transfers are that they feel that large companies are taking advantage of this, which they are allowed to do and is perfectly legal, and yet there is a feeling that somehow or other this is not right.

I am not prepared to argue that. I think it really boils down to can the Treasury afford to lose the revenue. I am not smart enough to answer that question I am sorry to say.

I can suggest one possible way out of it. It would be very simple to limit tax benefit transfers. In other words, you could say that one company could sell the benefits on up to 1 million dollars' worth of equipment during a period of a year. That would be very simple. The rest of your law would remain unchanged. The other factors which make the financing easier, which I think has to be recognized as good for the economy in every way——

Senator **Nunn**. You are saying reverse the present situation so that it benefits principally small business, instead of large businesses.

Mr. **Harris**. I am saying that if it is objectionable to see large companies avail themselves of this particular technique, that does not necessarily mean that this technique is bad in all cases at all times and in all situations.

I personally believe it could be a very positive factor, particularly for smaller companies. In my testimony I mention that our experience has been certainly not the big companies that are getting all the publicity. It depends of course on how you define small business.

I suspect from listening to these gentlemen here talking about the farmers that my initial gut reaction was a very correct one. There are a lot of companies, individuals, and farmers who could benefit from TBT's. I think you would have an obvious benefit. You would not have the political liability of having these big corporations appear to be beating the system and you do not throw the baby out with the bath water, which is what appears to be at least a possibility at this point.

Senator **D'Amato**. Mr. Finfer, do you have anything to say in response to that?

Mr. **Finfer**. Not really, Senator. I think it was very well covered by the various panels.

Senator **D'Amato**. Would you agree with Mr. Harris that that is a possible way to deal with some of these problems? You dislike TBT's in general, do you not?

Mr. **Finfer**. We do. I think the only difference is in approach. The approach offered by Mr. Harris, and I understand Treasury is considering it as is the Senate Finance Committee, is to limit it by dollar amount, keeping everything the same. That changes the regulations, which are restrictive. That must be addressed separately.

At the same time, our organization is leaning more——

Senator **D'Amato**. Of course that is always another problem. We have industrial revenue bonds and the problems with packaging them, and so forth. There is some hangup with their packaging. It just seems to me that that is something that they——

Mr. **Finfer**. Exactly.

And the at-risk rules which I heard were addressed earlier during other people's testimony fits in there, too.

The approach that the association is leaning toward now is a technical approach; to carve out the abusive areas and then to leave safe harbor in place with more lenient regulations so as to allow everybody to be treated equally.

The end result would be the preponderant use of safe harbor by small business and not by the large corporations.

Senator D'AMATO. Let me thank the panel for their participation and their patience. Let me also indicate to you that I know this committee has been substantially enriched as a result of your testimony and your expertise. I have more mixed feelings in regard to where we go now, but you certainly have given us a wealth of thought. If you do have any ideas in terms of specific legislative initiatives in addressing this problem that you have not submitted or that you care to capsulize to us, this committee stands ready to receive that.

[The prepared statements of Mr. Harris, Mr. Finfer, and Mr. Mulenholz follow:]

STATEMENT BY

MR. MILTON M. HARRIS, PRESIDENT, MARYLAND NATIONAL LEASING CORPORATION
300 East Joppa Road, Towson, Maryland
Before Subcommittee on "Safe Harbor Leasing"
Senate Small Business Committee
March 2, 1982

I have been engaged in the equipment leasing business for over nineteen years, chiefly in various management positions. Prior to that, my experience includes various types of consumer and industrial finance and investment banking. Maryland National Leasing Corporation, although part of a large organization, was originally capitalized eight years ago with $100,000. Thus, I feel I have some familiarity with small businesses both as a lender and as an operator of such a business.

Major corporations in the United States have access to a number of sources of funds. These include the bond market and the stock market, both sources of long term financing, insurance companies as sources of long term fixed rate debt, foreign and domestic banks as sources of fluctuating rate short term capital and most have access to the commercial paper market, providing them with short term floating rates with the lowest interest rates possible.

In contrast, smaller companies find their financing mainly from banks from which they obtain usually short term fluctuating rate loans and equipment leasing companies which are often their only source of long term fixed rate financing. Thus, small companies are at a distinct disadvantage in financing their growth when compared with larger companies. The only exception is the high technology, glamourous, high growth company where it is possible to raise equity capital from the public.

In addition, many foreign countries offer tax breaks which make the Economic Recovery Tax Act of 1981 appear to be very stingy indeed. For instance, if a corporation in the United Kingdom buys $100,000 worth of equipment, they are allowed to claim a depreciation of the full 100% the very first year. Assuming they are in a 50% corporate tax bracket, they thus recover 50% of their cash within twelve months. An American corporation purchasing $100,000 worth of equipment under the new Act recovers $10,000 from the Investment Tax Credit, is allowed to depreciate $15,000 the first year and thus recover a total of $13,750 as opposed to the $50,000 recovered by their United Kingdom competitor. I understand that other foreign countries offer comparable incentives.

The point of all this is that small businesses have an extremely difficult time in obtaining financing. It must be recognized that any business, large or small, fears uncertainty, particularly uncertainty as to future income tax requirements. Most businesses, regardless of size, attempt to perform either formal or informal planning of future cash flows. Without such planning, any business stands a good chance of going bankrupt. Often, construction times for new buildings may necessitate making plans several years in advance. Equipment deliveries are often uncertain and thus, cash planning is essential.

At the same time, I think it only realistic to admit that tax incentives alone will not cause an improved economy. However, in our present high interest rate environment, coupled with a slow economy, any additional assistance such as tax incentives provided under the Economic Recovery Tax Act and the Safe Harbor provisions of Section 168F8 are certainly steps in the right direction. The experience of Maryland National Leasing Corporation during the last year's rush to buy and sell tax benefits by the end of the year was as follows:

We packaged a total of 64 transactions with a total equipment value of $87,599,893.99. The average size of our transactions was $1,368,748.34. Of these transactions, 40, for a total of $66,219,037.79 were tax benefit transfers. The average size of such transfers was $1,655,475.95; 24 transactions were 100% financing and totalled $21,380,856.20 for an average of $890,869.01. It is interesting to note that, of these transactions, 30 were for either banks or Savings & Loans where selling of tax benefits benefitted not only their shareholders but their depositors since it strengthened their equity base. I regret to advise you that we also were forced to reject approximately the same number of transactions, some with quite large corporations, although many were with very small corporations. We were unable to handle these transactions because of the uncertainty as to the treatment of purchased tax benefits should the seller enter bankruptcy. To date, this uncertainty has not been completely resolved.

The equipment leasing industry in the past has been in the business of financing equipment for all size companies and, as I mentioned previously, has often been the only source of long term fixed rate financing for small companies. We feel that the passage of the Economic Recovery Tax Act and particularly the Safe Harbor provision, has enhanced our ability to serve the public and provide financing to companies which otherwise might be unable to obtain it at any price. My purpose in coming here, however, is not only to recap the past but to make some suggestions for the future.

1) If you wish to help business in general and small business particularly, it is necessary to recognize that a steady policy, even if imperfect, is preferable to a constantly changing tax situation which only helps to confuse businessmen and to delay their plans for expansion. Any tax policy should be as simple as possible and should be changed as infrequently as possible.

2) It should be recognized that the passage of a minimum tax implies two things -

   a) That the present tax structure is unfair and should be revised, and

   b) That we wish to add to the burden of corporations already in trouble.

   To my mind, the answer is not a minimum tax but a general revision of tax laws and, particularly, taxable deductions.

3) Treasury Regulations should be written providing that in case of bankruptcy, all aspects of a tax benefit transfer will be considered as continuing as if no bankruptcy had occurred. This is the best way to assist troubled and new companies to obtain financing through the sale of their tax benefits.

4) It should be recognized that Section 168F8 is an aid to business that probably costs the Treasury very little except for the tax benefits transfer provisions. The other provisions of Section 168F8 only serve to make lease financing a more realistic,generally accepted financing vehicle. Thus, if experience proves that the tax benefit transfer provisions are causing unacceptable losses to the Treasury, change these provisions only. A simple revision forbidding the Lessor to borrow from the Lessee would probably be the major change necessary. Then, only 100% financing type leases would be allowed as before the passage of the new Act and straight tax swaps would be impossible.

5) The Treasury should be instructed to consult with interested parties before issuing regulations affecting those parties. By this, I don't mean lobbyists, I mean actual business people who are familiar with the day to day problems involved. Often, Treasury Department regulations appear to be issued from an ivory tower, not the real world.

In this testimony I have attempted to be brief since I realize your time is limited. Thank you for the opportunity to speak before the Committee. I would be most pleased to be of any further service at any time. Please call upon me if I may help in any way.

SAFE HARBOR

STATEMENT OF PAUL M. FINFER
ON BEHALF OF
THE AMERICAN ASSOCIATION OF EQUIPMENT LESSORS
BEFORE THE
SENATE SMALL BUSINESS COMMITTEE
MARCH 2, 1982

Mr. Chairman and Members of this Committee:

Thank you for this opportunity to discuss the subject of small business and the so-called "Safe Harbor" leasing provision (Code §168 (f)(8)) of the Economic Recovery Tax Act of 1981. Today I am speaking on behalf of the American Association of Equipment Lessors (AAEL), an Assocation of over 800 member corporations that are actively engaged in equipment leasing.

Our conclusion on the value of "Safe Harbor" leasing for small business is that some modification of the "Safe Harbor" leasing provisions should be made to make them more accessible to small business. Current "Safe Harbor" rules are too cumbersome and restrictive. They make it unduly difficult (and sometimes competitively disadvantageous) for many small businesses to utilize "Safe Harbor" leasing. We specifically urge modification of the "at risk" restrictions and the allowance of more than one "Safe Harbor" election for equipment, to facilitate "Safe Harbor" leasing by small business

I. Overview of the Equipment Leasing Industry.

While equipment leasing cannot be defined as one typical type of transaction, our industry can generally be described as follows. The growing number of companies that use lease financing believe that use of equipment is more important than ownership of the equipment. While transportation equipment, computers, electonic business equipment, and manufacturing equipment account for nearly half of the dollar volume of equipment leased, lessees lease practically every type of commercial asset. Lessors provide 100% financing at a fixed price (periodic rental payment) for an intermediate term. Historically, most leases contained a fair market purchase option at the end of the lease. Under "Safe Harbor" provisions of the Economic Recovery Tax Act of 1981, purhcase options at less than fair market value may now be included in the transaction. Depending on the dollar size of the transaction and the type of equipment these fixed price purchase options normally are ranging from 5% to 20%. Many transactions, however, continue to contain fair market purchase options. The latter does tend to keep the lease payments at a lower level. In such leases, the lessor enters into a transaction with economic substance. He takes an equity position as an investor in equipment, provides funds, and may ultimately remarket the equipment at the end of the lease. Equipment leasing has been a continually growing primary method of equipment finance for over 25 years. In 1981, equipment leasing financed approximately $40 Billion worth of equipment. Many of our industry's customers, the lessees, are small businesses. They utilize leasing because it is convenient, fixed rate, 100% financing. Traditionally, these latter criteria have been more important to the small size lessee than tax benefits or imputed cost of funds. Transactions with small businesses have not generally been tax oriented. The small businessman does not have the extra time or personnel to arrange complicated financing. The transaction is done on standard forms, and is based on a standard credit policy of the leasing company.

II. Safe Harbor leasing for Small Business.

These comments are based on telephone interviews with a sample of leasing companies that do leases with small businesses.

The "Safe Harbor" leasing provision (168(f)(8)) has not impacted small business' use of lease financing significantly. "Safe Harbor" has given rise to many variations of so-called lease transactions. However, most of these transactions can be characterized as either Tax Benefit Transfers (TBT) or conventional (economically substantive) leasing done under "Safe Harbor". The TBT has received most of the criticism. It is the selling and buying of tax benefits. The nominal lessor does not finance equipment nor does he even own it, he just buys the tax benefits of a corporation that has no current tax bill against which to use earned tax benefits. The TBT is the type of transaction that the creators of "Safe Harbor" intended to promote. The nominal lessors in TBT's are not usually financiers of equipment nor are they conventional lessors. They very rarely take title to equipment, they don't contribute investment funds, and they don't assume economic risk apart from the possbile loss of tax benefits in some cases.

Today equipment lessors are continuing to do lease transactions with economic substance under "Safe Harbor". In fact, the majority of transactions under "Safe Harbor" are such leases, not TBT's. Many of the transactions are with small businesses. "Safe Harbor" does provide new flexibility for lease transactions which may benefit lessees. "Safe Harbor" permits purchase options at less than fair market value and a wider variety of equipment can now be leased and under terms which are inducements to lower rates. For purposes of my testimony today, I will refer to these transactions as conventional leases under "Safe Harbor". Making such conventional leasing more efficient and attractive through "Safe Harbor" was not the primary intent of the creators of the "Safe Harbor" provision. It has been a by-product. In short, "Safe Harbor" in practice has not significantly benefited the smaller business because it was never intended to do so. The TBT was intended to help large corporations with earned tax benefits and no tax bill.

To put in perspective the problems of small business in utilizing "Safe Harbor" leases, it is helpful to consider the more general subject of commercial lending to small business. After all, whether a TBT, a conventional "Safe Harbor" lease, or a non "Safe Harbor" lease, it is obtaining in effect a form of commercial finance. The criteria for providing a commercial loan to a small business apply. The credit worthiness of the small business compared to the large is critical. The transaction costs for the lender are often as high to do a small transaction as a large. A large transaction covers the overhead more than the small transaction does. Ordinarily a smaller commercial transaction will be considered only if the transaction meets standard tight credit policies, utilizes standard documentation with no variations, and is done at a higher margin or fee. All else being equal, given a finite availability of funds, lenders, whether buyers of tax benefits, conventional lessors, or commercial lenders, will use those funds in a few large transactions rather than many small transactions. In addition, the effective rate paid by the small business will of necessity be higher because of basic transaction costs and risks. The conclusion that "Safe Harbor" "insures availability of investment incentive to all", "should benefit small, new and fast growing firms", and "improves economic efficiency by removing tax induced competitive disadvantages" cannot be accurately reached due to the nature of the investment vehicle created.

Although perceived otherwise by its creators, guidelines established by the Internal Revenue Service have eliminated the possibility that "Safe Harbor" leasing would impact neutrally on companies in the marketplace. The purchase of tax benefits under the Act is equivalent to making an unsecured loan to the seller of tax benefits since under the IRS regulations a number of circumstances could cause the buyer "lessor" to lose the tax benefits before he realizes their benefit.

Consequently, credit worthy companies (i.e., those who have the ability to borrow on an unsecured basis) have an advantage over those companies whose credit does not permit such financings, specifically small companies, new companies with little capital and unproven growth, and the weak companies within any industry.

It should be noted that the concern about the neutrality issue has, in fact, been reflected in the marketplace. Companies whose credit ratings are Baa or better have had little difficulty selling tax credits and, in recent months, at prices which are at least equal to the present value of those credits. On the other hand, smaller and weaker companies have either been excluded from selling their credits or have had to provide additional security in order to do so or accepted a lower price, or both.

Making "Safe Harbor" completely neutral could be possible if IRS guidelines were revised. However, this would again have an adverse effect on the smaller and weaker companies since their ability to access the secured debt market -- an important part of their capital structure -- would be inhibited. Secured lenders recognize that the value of repossessed collateral is eroded if a potential buyer of that collateral is unable to realize depreciation because the "intangible asset" (tax benefits) has already been disposed of. Hence, secured lenders would restrict advances made on a secured basis by at least as much as the value of the tax benefits.

III. Making "Safe Harbor" More Efficient for Small Business.

"Safe Harbor" was adopted as an alternative to refundable investment tax credit. Not only was "Safe Harbor" more politically acceptable than refundability, but it provides a mechanism to police the exchange of tax benefits that refundability could not provide. Through strict and complicated regulations (over 70 pages of IRS regulations to deal with one page of a statute), "Safe Harbor" puts the monitoring and reporting burden on the nominal lessor. The regulations adopted under the Act provide such penalties for the buyer of tax benefits or "Safe Harbor" lessor if property is transferred or becomes unqualified, and requires such documentation to be made, that the overhead costs per transaction are high. To "Safe Harbor's" credit, the extensive regulations do prohibit the terrific abuse that could have and would have occurred under refundable ITC due to the absence of any effective monitoring system.

The "Safe Harbor" regulations limit the timing of deductions of tax benfits of seller/lessee companies subject to the at risk rules. Most small businesses are subject to the at risk rules, and therefore are not attractive as sellers of tax benefits. As public corporations are not subject to the at risk rules, they are attractive sellers of tax benefits. The obvious reality then is that the TBT lends itself to large dollar transactions with public corporations, and to transactions where the risks to the nominal lessor (TBT buyer) are minimized by the size and credit worthiness of the TBT seller. These realities work against the likelihood of a small business being able to sell the tax benefits on the several hundred thousand dollars worth of equipment in which he invests per year. For small businesses, the conventional lease under "Safe Harbor" is an attractive financing method. Conventional equipment lessors can do conventional leases under "Safe Harbor" to small businesses more efficiently and effectively than nominal lessors, buyers of TBT's, can do TBT transactions. Conventional leasing companies already have a marketing mechanism and administrative mechanism in place to execute and administer the lease. Many leasing companies are set up to specialize in this market area. The transaction tends to be standardized to keep costs effective and the operation is set up to provide quick and convenient financial service which is what the small business owner primarily wants. Because the transaction has economic substance and the lessor has title to the equipment and is entitled to the tax benefits, it is a more attractive commercial transaction to lessors than is a TBT. The benefit to the small business is that it acquires the use of equipment and cost effective financing.

While "Safe Harbor" conventional leases can be helpful to small businesses, the "Safe Harbor" regulations do several things which chill using any "Safe Harbor" transaction with small business. Again, please keep in mind that the regulations were adopted to monitor multi-million dollar transactions and prevent abuse. We do not quarrel with that intent. But small businesses do suffer under the restrictive IRS regulations (and burdensome reporting requirements) for "Safe Harbor".

Efficient use of "Safe Harbor" by small businesses through conventional leasing requires that conventional leasing companies use their mass marketing and administrative organization to provide quick and convenient financing. But while a leasing company can give a quick commitment for lease financing to a small business by virtue of this organization, the leasing company is limited in its volume by the "Safe Harbor" regulations. Leasing companies, as other taxpayers, have a limited tax liability. When considering leases, it is more efficient to do a few large equipment leases rather than many small equipment leases to accrue tax benefits of equipment ownership. One particular provision of the "Safe Harbor" regulations severely limits equipment lessors from using their mass marketing and administrative structure to help small businesses benefit from investment incentive tax benefits. The regulations provide that only one "Safe Harbor" transaction can be done on an item of equipment. This limits the conventional leasing company. If conventional lessor A does a conventional "Safe Harbor" lease to small business B, then the regulations prevent A from in turn selling some or all of these leases to secondary funding source C in a "Safe Harbor" lease because that equipment has already been the subject of a "Safe Harbor" lease. If two "Safe Harbor" leases were allowed for an item of equipment, we could combine the ability of a conventional lessor to provide mass funding to small businesses with the financial size and leverage of the leasing company which can bundle them into one large attractive financial product for a major institutional lender which would not otherwise deal directly with small businesses.

IV. Conclusions.

To summarize, as the Congress considers legislation to repeal or amend "Safe Harbor", we urge it to consider that the abuses of "Safe Harbor" that have attracted so much attention and caused so much concern were actually TBT transactions. These TBT transactions, as a practical matter, have not been significant for small businesses, but only for large corporations. To some extent, small businesses have used "Safe Harbor" to enter into conventional leases with equipment lessors to acquire productive equipment at an efficient cost. AAEL recommends that the Congress consider amendments to the "Safe Harbor" provision and the IRS regulations to encourage small business and allow more efficient use of conventional economically substantive leasing within "Safe Harbor".

Thank you.

NATIONAL FARM AND POWER EQUIPMENT DEALERS ASSOCIATION
STATEMENT BEFORE THE
SELECT COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

March 2, 1982

Mr. Chairman and Members of the Subcommittee:

My name is John Mullenholz and I am Legislative Director of the National Farm and Power Equipment Dealers Association, an organization representing over 10,000 businessmen and women who sell and service the equipment which runs the farms and industries of this nation. With me is Mr. Thomas Huset, President of Association Credit Plans Incorporated.

Our purpose here today is to seek the help of this Subcommittee and of the Full Select Committee on Small Business in reversing the decision of the Chairman of the Finance Committee, announced in February to the effect that the "safe-harbor leasing" provisions of the Economic Recovery Tax Act of 1981 would be eliminated retroactively to the date of the announcement.

Senator Dole's decision works particularly to the disadvantage of the small businessman for a number of reasons. The billions of dollars of tax credits and cost recovery deductions which have been traded among the large corporations in this country, and about which we have read so frequently over the last several months, were only possible through substantial expenditures for sophisticated legal and accounting advice. The small businessman does not have that luxury and, therefore, must await the development of programs which he can adapt to his own operation. Such plans and programs were just becoming available in the farm and power equipment industry when the decision was made to withdraw the safe-harbor leasing provisions.

Another factor delaying implementation of the safe-harbor leasing provisions by the small business community is the educational process necessary to bring the advantages of the provisions to the attention of the small businessman. Psychological and emotional objections to new methods of financing are also serious obstacles to implementation of any safe-harbor leasing programs.

In our industry, Mr. Huset and his organization have spent several months of time, money and effort in devising a program and obtaining the approval of the Internal Revenue Service. Announcement of the plan was to take place this month absent Chairman Dole's decision to eliminate the safe-harbor leasing aspects of the 1981 Act.

The significant impact of the safe-harbor leasing provisions for the farmer and other equipment purchaser is a reduction in the effective interest rate on the cost of the purchase. The fact that a smaller amount will be borrowed as a result of using the safe-harbor leasing provisions causes a substantial reduction in the interest as a percent of the total cost of the equipment. Leasing programs can also act as a catalyst for bringing new and greatly needed funds into the farm economy. Perhaps the most vivid evidence of the interest rate problem is the fact that farm debt as January 1, 1982 exceeded $194 billion, an increase of almost 300% since 1975. Interest on this debt will far exceed $25 billion in 1982. One of our dealers from Corning, Arkansas, recently compiled statistics which show that interest was the largest single expense in farm operations in his county during 1980 and 1981. Prior to that time, it was not even among the four highest farming expenses.

Concern over high interest rates has been expressed continually by Senators and Congressmen on both sides of the aisle and particularly members of the Small Business Committees in both Houses. Retention of the safe-harbor leasing provisions for small businesses is one positive step which the Congress can take toward effectively reducing interest rates.

Clearly, there is pressure upon Congress to make changes in this area of the law. However, it does not necessarily follow that the leasing provisions must be eliminated in their entirety. The intention of Congress in enacting these provisions, we believe, was to spur capital investment in those firms which needed it most, principally, those which did not have taxable income and, therefore, were not able to take advantage of the new accelerated cost recovery system. Examples which have come to light of massive sales of credits and losses among large corporations have created a hostile attitude toward these provisions in the public mind.

This attitude, fortunately, does not extend to small business or the farming community. It would, therefore, seem appropriate, if this Congress decides to make some change in the safe-harbor leasing provisions, that they be limited in their applicability as opposed to a total revocation. By retaining the advantages of these provisions for small business, the Congress would be able to assure that its original purpose was carried out. This is so because purchases of equipment and other assets by small business have a far greater impact upon the economy than large businesses, and, in turn, more jobs are created by small business.

Thank you for the opportunity to appear and give you our comments. If there are any questions we would be most happy to attempt to provide answers.

National
Farm & Power Equipment
Dealers Association

Future Planning Analysis-External Evaluation

Prepared for . . .

National Farm & Power Equipment Dealers Association

10877 Watson Road • St. Louis, Mo. 63127 • 314/821-7220

August 1979

**A Project of NFPEDA's
Task Force for the Future**

DEDICATION

This Study is a direct result of the first order of business undertaken by Herb Gettel after his inauguration as president of the National Farm & Power Equipment Dealers Association at the 79th Annual Convention.

At that time he announced the appointment of a Task Force for the future and charged the group with providing dealers and NFPEDA with a "grand strategy to guide our course in the years to come".

The Task Force, composed of NFPEDA directors, affiliate association managers, past NFPEDA presidents, representatives of suppliers and other experienced, interested parties, was asked to direct its attention, its leadership, and its energies toward the study of major American needs in general and the farm and power equipment industry in particular.

President Gettel reminded the Task Force, "As we look toward the turn of the 21st century, we want to be ready to meet the challenge of tomorrow in the best possible manner".

The Task Force then elected to engage Doane Research Services for actual work in researching, surveying, and compilation of survey results appearing in this report. It is an external evaluation, produced in an impartial manner.

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IMPORTANCE TO AGRI-BUSINESS

-- Farm size will increase twelve percent in the next five years. Along with total farm size will be an increase in average field size.

-- Farmers with livestock will be increasing their operations also, from twenty-one percent increase for poultry to a sixty-three percent increase in beef cattle.

-- Farmers feel equipment size will keep increasing in the future. They say there is a eighteen to nineteen foot physical limitation set by roads, gates and storage entrances.

-- Equipment is kept from seven to nine years. Crop harvesting equipment is kept an average of seven years and small tractors and tillage equipment is kept an average of nine years.

-- Farmers would use equipment made in modular components. These farmers would also pay a slight premium to get their equipment back into use faster.

-- Farmers would use a parts and service substation if it was located closer to their farms.

-- When farmers select a farm equipment dealer, they first look at parts availability and service capabilities. Then at line of equipment, location of dealership, relationship with dealer, and amount of time dealership is open.

-- Computer programs will be used in the future to make farmers more efficient. Major areas for programs are financial areas (farm records, income taxes, profit/loss). Other areas are fertilizer application, feed/nutrition schedules, and machinery economics.

-- Farmers say their tillage practices will change in the next five years, especially as fuel costs keep increasing.

-- Leasing will become more popular in the future, due to increasing equipment prices and farmers wanting to improve cash flow.

-- Farmers feel a maintenance seminar would be helpful to them. An area they would like to see covered is regular maintenance they can perform themselves.

-- Farmers receive an average of four newsletters a month. Most farmers want information on price forecasting and marketing.

-- Farmers travel an average of one hundred miles to attend farm shows. They go to see new machines, new products, and new ideas.

-- Farmers feel lobbying by organization like American Farm Bureau Association, National Cattlemen's Association, Farmers Union, etc. is beneficial to them. They want to see legislation on control of government regulations, taxes, and stabilization of grain prices.

IMPORTANCE FOR DEALERS

-- Dealers must have physical facilities large enough to handle the increasing size of equipment.

-- With equipment being kept longer, dealers will have to keep a close watch on parts inventory to be able to handle a majority of farmers needs.

-- Dealers will have to decide if they want to provide a leasing service to their customers as equipment prices rise.

-- Dealers must provide good parts availability and service capabilities to retain current customers and recruit new customers.

-- For a parts and service substation to work, a dealer must still provide good parts and service work to his customers.

-- Dealers can help their customers make the right equipment decisions, as farmers try to become more fuel efficient in their tillage operations.

-- Dealers should explore the feasibility of offering a computer program to their customers on machinery economics and machinery maintenance.

-- A maintenance seminar for customers can be a good customer relations program for dealers.

-- Dealers should be aware of legislation affecting their customers. This can be done through affiliate and national associations. The associations should not get involved with general farm legislation, there are many other areas directly affecting dealers the association should be involved with.

-- Computers are going to be a necessary tool for equipment dealers. For dealers to survive they must have an efficiently run operation, from new equipment and parts inventory to financial information. They must receive this information quickly to keep a close watch on an operation. A computer will help dealers stay in business.

FARM SIZE

Farm size is going to increase in the next five years. A majority of farms will still be under five hundred acres. However, these smaller farms are decreasing in number (Figure 1). Farms above five hundred acres will increase in number.

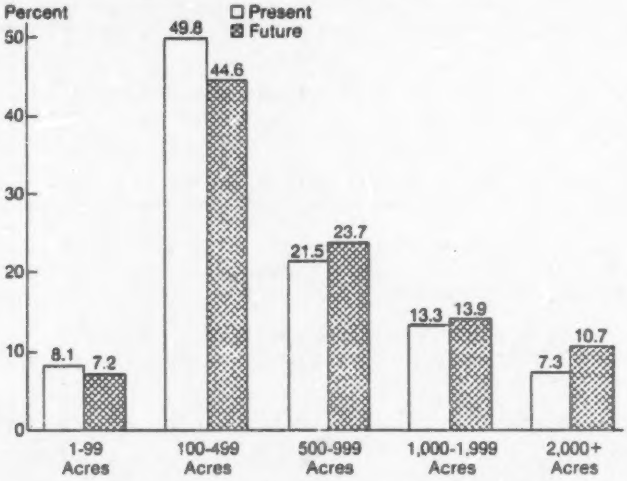

Figure 1 — Percent of Farms Now and in the Future by Farm Size

According to farmers in the Study, current average farm size is seven hundred and twenty-seven acres. Average farm size in five years will be eight hundred and twelve acres. This is an increase of eleven percent. Average field size will also increase by the same percentage, from fifty-four acres to sixty-one acres.

Increases in livestock will also occur in the next five years:

	% IN FARMS WITH LIVESTOCK	AVERAGE NUMBER/FARM	FUTURE AVERAGE NUMBER/FARM	PERCENT INCREASE
Beef cattle	54	122	200	63
Hogs	23	321	485	51
Dairy cattle	22	83	103	24
Poultry	12	3,090	3,743	21

EQUIPMENT SIZE

A majority of farmers see all types of equipment increasing in size, except for forage harvesters.

	% SAYING SIZE WILL INCREASE
Tractors	78
Combines	66
Discs	70
Moldboard Plows	61
Chisel Plows	61
Corn Planters	62
Grain Drills	54
Forage Harvesters	43

Three hundred horsepower is an average of the maximum tractor size, farmers see in the future. Forty-seven percent of the farmers who, feel tractor size will increase, say maximum size will be over three hundred horsepower (Figure 2), with over seventeen percent saying maximum size will be five hundred horsepower and above.

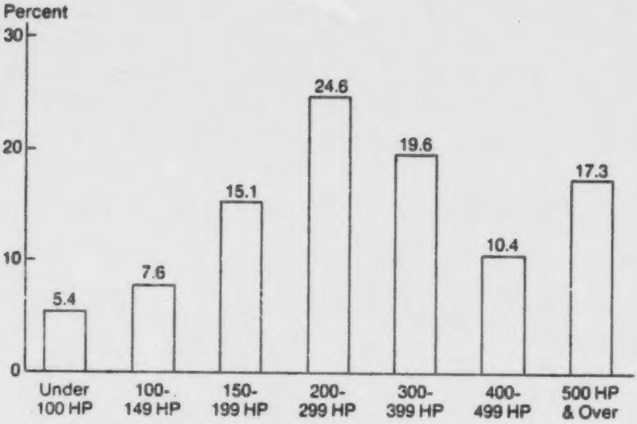

Figure 2 — Maximum Horsepower in Next Five Years

Forty-one percent of the farmers plan on increasing their tractor horsepower in the next five years. Average tractor size farmers will increase to is one hundred sixty-five horsepower. The one hundred fifty to two hundred horsepower range is where the biggest increase will occur, thirty percent. Twenty-seven percent are planning to increase to two hundred or more horsepower.

	% OF FARMERS PLANNING TO INCREASE TRACTOR SIZE
Under 100 Hp	15
100-149 Hp	28
150-199 Hp	30
200 and over	27

Length of time farmers keep tractors is one reason for only forty-one percent increasing their size of tractors. On the average farmers plan to keep large tractors eight years. Sixty-four percent plan to keep their large tractors longer than five years (Figure 3).

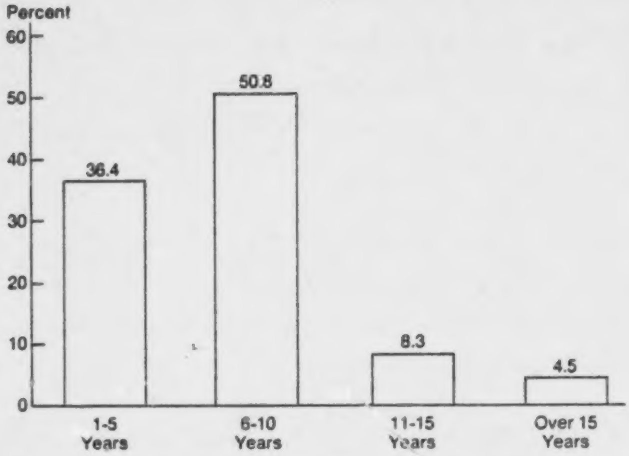

Figure 3 — Length of Time Farmers Keep Large Tractors

Farmers keep small tractors longer, sixty-nine percent keep their small tractors longer than five years (Figure 4). This comes out to an average of over nine years.

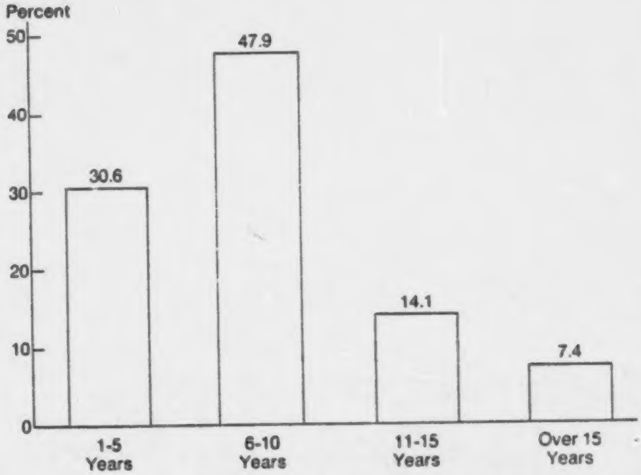

Figure 4 — Length of Time Farmers Keep Small Tractors

Eight row corn heads and twenty-three foot cutter bars are the average maximum sizes farmers feel combines will increase to. Thirty-two percent say maximum rows on a corn head will be twelve and twenty-two percent say thirty feet is the maximum width for a cutter bar.

Twenty-two percent of the farmers say they will increase their combine size in the next five years. Six row corn heads and nineteen foot cutter bars are the average sizes farmers say they will be increasing to.

Farmers keep combines an average of seven years. Forty percent keep their combine between one and five years (Figure 5). Ninety percent keep combines less than ten years.

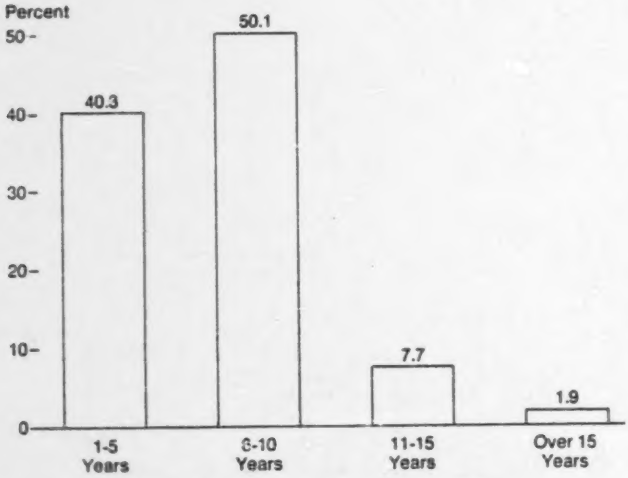

Figure 5 — Length of Time Farmers Keep Combines

Farmers feel tillage equipment will be getting bigger in the future. On the average, a moldboard plow will have eleven bottoms, a disc will be twenty-nine feet wide and a chisel plow will be twenty-five feet wide.

Twenty-one percent of the farmers will increase the size of their moldboard plow, thirty percent their discs and eighteen percent their chisel plows. Average for moldboard plows is six bottoms, with seven percent increasing to over ten bottoms. Average for discs is twenty feet wide and fifteen percent increasing to more than a thirty foot width. Twenty feet is also the average for chisel plows, with seventeen percent saying over thirty feet wide.

Farmers keep tillage equipment an average of nine years. Fifty-six percent keep tillage equipment between six and ten years (Figure 6).

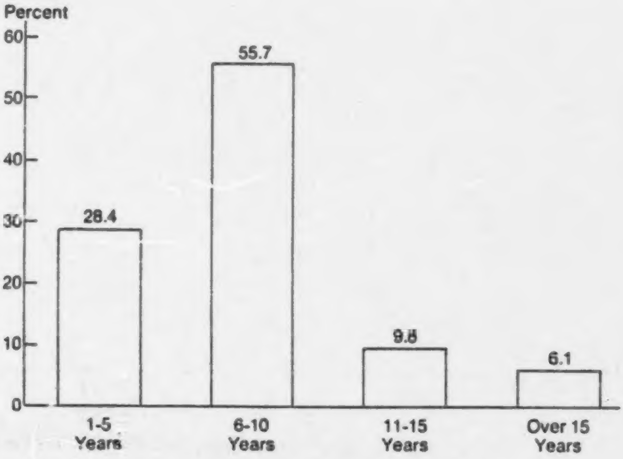

Figure 6 — Length of Time Farmers Keep Tillage Equipment

Sixty-two percent of the farmers felt corn planters will increase in size and fifty-four percent felt grain drills will increase. Average maximum size for corn planters is sixteen rows, thirty percent of the farmers who feel size will increase think it will be over sixteen rows. Twenty-four feet is average maximum width for grain drills. Twenty-nine percent feel the size will be over thirty feet for grain drills.

Nineteen percent of the farmers will increase their corn planter size and fourteen percent will increase their grain drill size, with increase to eight rows and nineteen feet respectively.

Farmers keep planting equipment an average of eight years. Sixty percent keep planting equipment longer than five years (Figure 7).

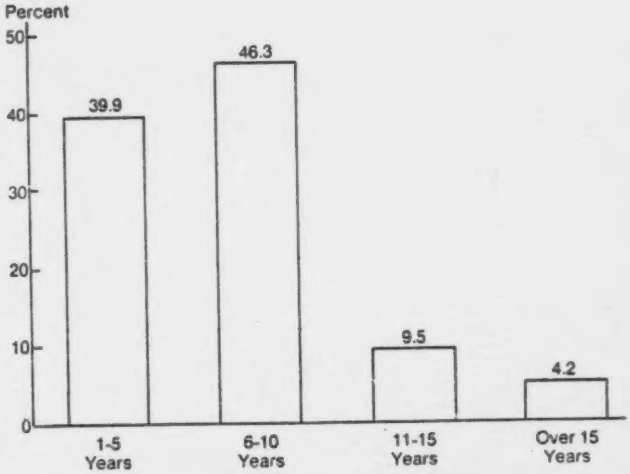

Figure 7 — Length of Time Farmers Keep Planting Equipment

Only forty-three percent of the farmers feel forage harvesters are going to increase in size. Five row headers and fourteen foot cutter bars are the maximum size for forage harvesters.

Six percent of the farmers are going to increase the size of their forage harvesters. Average size will be three row heads and twelve foot cutter bars.

Forage equipment is kept the same length of time as a combine, seven years. Ninety percent keep forage equipment less than ten years.

Farmers say certain physical surroundings will restrict their equipment size in the future. Some of the restrictions are:

	% SAYING THEY WILL RESTRICT	AVERAGE MAXIMUM WIDTH
Road width	56	18 ft.
Gate width	47	19 ft.
Storage facilities entrance	47	18 ft.

To handle most width restrictions, equipment must be able to be transported at a fifteen feet width. This will take care of approximately seventy percent of all maximum width requirements (Figure 8). Road width is an important restriction, the average of the maximum distance between tracts of land is seven miles.

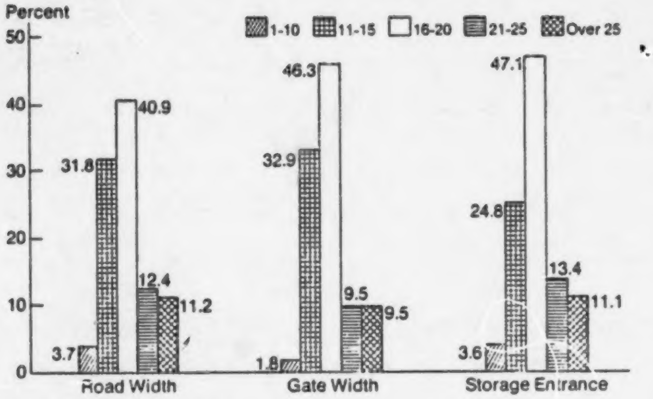

Figure 8 — Maximum Width Requirements for Machinery

Farmers like the idea of equipment being made in modular components. Sixty-nine percent of the farmers say they would be willing to buy machinery made in modular type components. Sixty percent say they would pay more money for a module. Sixty-seven percent, of the farmers who would pay more for a module, say they would pay at least five percent more than what parts and labor would cost on a regular machine (Figure 9).

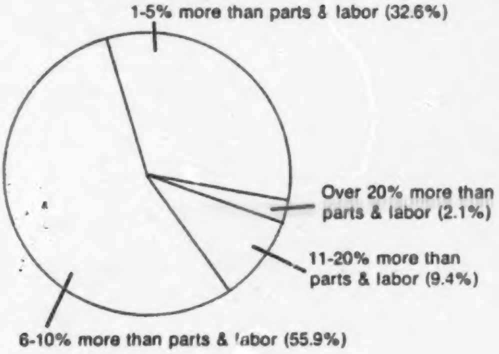

Figure 9 — How Much More Farmers Would Pay for Modular Components

IMPORTANCE FOR DEALERS

Equipment is going to get bigger. To handle this, equipment dealers must have physical facilities large enough to handle a large majority of equipment.

Farmers are keeping equipment longer as prices increase. They will be putting more money into parts and service to keep equipment running longer. Dealers must realize this to help in their parts inventory control, so they have specific parts when needed.

Dealers can benefit from having access to reference material on new building designs, floor layouts, etc.. Affiliate and national associations should provide information to dealers if they are planning to expand their facilities.

For dealers to provide maximum service to their customers in the area of parts, dealers must have an efficient parts inventory program. One way to achieve this is through computerization. Dealers, to survive must have access to a computer system to efficiently run their operations.

DEALER SELECTION

Parts availability and service capabilities are the two most important reasons to farmers when selecting an equipment dealer (Figure 11). Then comes line of equipment handled, location of dealership, relationship with dealer, and finally amount of time dealership is open.

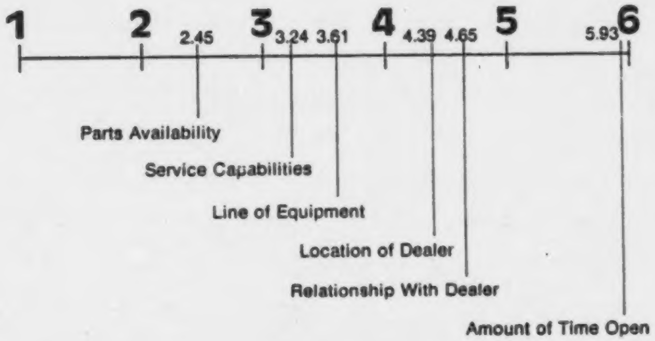

Figure 11 — Median of Rank of Importance in Selecting a Farm Equipment Dealer

Farmers do not go to the nearest equipment dealer for the majority of their equipment needs. The average distance for the nearest farm equipment dealer is twelve miles, while the average distance to the dealer handling a majority of the farmers equipment needs is sixteen miles (Figure 12).

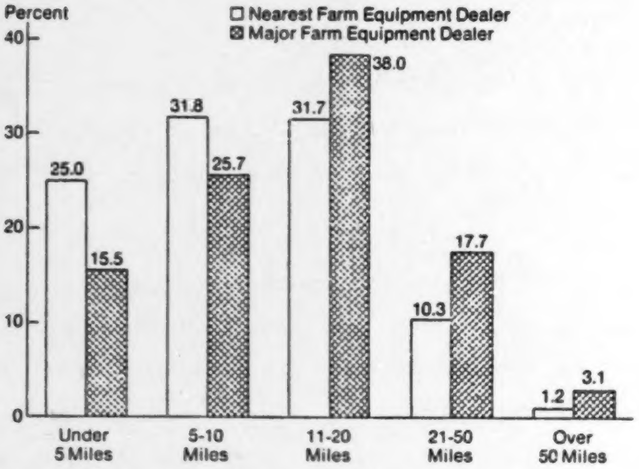

Figure 12 — Distance to Farm Equipment Dealers

Fifty-nine percent of farm equipment customers travel more than ten miles to a dealership. Farmers are going to dealers giving them the parts and service they want.

Farmers say they would use a parts and service substation if it were located closer to their farms. Seventy-eight percent of the customers would use a substation. Farmers who would not use the substation feel they are close enough now, the substation would not have parts/service needed, or the substation would add extra costs onto parts and service.

IMPORTANCE FOR DEALER

Farmers look at parts availability and service capabilities first when selecting a dealer. For dealers to retain the customers they already have and recruit new customers, parts and service is the way to do it.

Dealers must look at providing the best service and most parts, yet still run an efficient and profitable operation. Computerization is one way to do this. Dealers can carry only so much parts inventory and do so much service work per man hour. A computer can help dealers maximize their efforts in these areas.

Farmers say they would use a parts and service substation if it were located closer to their operation. Dealers must decide if this concept will work in their area. They have to make sure they still provide the best parts and service capable. A substation will not work if farmers do not get the same kind of service they would from the "full service" dealership.

TILLAGE PRACTICES

Fifty-three percent of the farmers feel their farm machinery requirements will change in the future because of fuel costs. A big change will be elimination of some field operations. Farmers are also going to more fuel efficient methods by matching tractor and implement sizes.

Fuel costs are going to change fifty-nine percent of the farmers tillage methods in the future. Ways tillage practices will change are:

	% OF FARMERS FEELING TILLAGE METHODS WILL CHANGE
Go to minimum tillage	35
Fewer trips over fields	23
Go to no-till	9
Multiple operations	7
Bigger equipment	5

A move toward less tillage is seen in how farmers say they will till in the future (Figure 13). Forty-five percent currently use conventional tillage, only twenty-six percent say they will use conventional tillage in five years. Biggest increase occurs in minimum tillage going from twenty percent to thirty-six percent in five years.

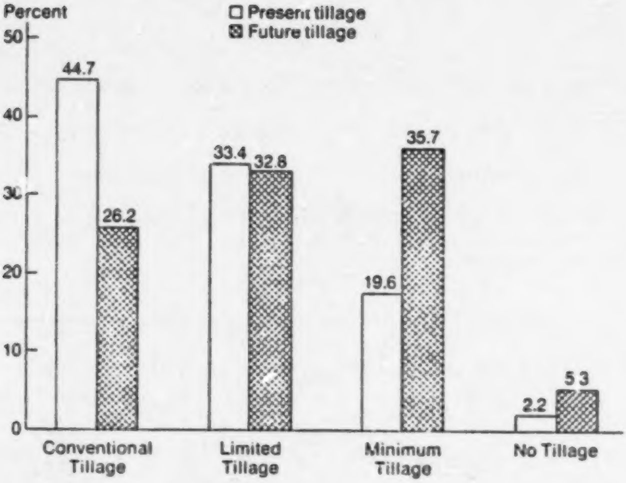

Figure 13 — Current and Future Tillage Systems

It is felt farmers talk about minimum tillage in terms of machinery reduction rather than conservation of soil residues. Farmers are going to fewer trips across the field and combined operations, but the amount of soil residue is basically the same.

There is interest in use of power tillage type equipment. Just under fifty percent of the farmers feel a future for this type equipment is good to excellent (Figure 14).

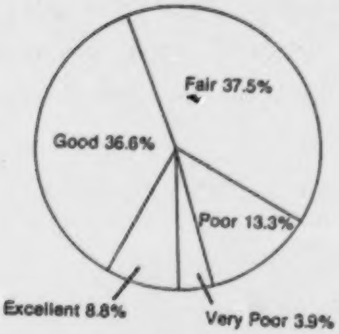

Figure 14 — Future of Power Tiller Type Equipment

Things farmers will look at before they consider a power tiller are:

	PERCENT
Right price	25
Demonstration	16
Fix rock problem	7
More land	6
Something faster than present	6
Ability to cover large acreage in less time	6

Farmers are businessmen. Before they will consider a power tiller they must be shown it will profitably help their operation. This is a key point for the manufacturers who are thinking about this market.

IMPORTANCE FOR DEALERS

Farmers will be changing their field operations in the future. They will do this through fewer trips across the field and more fuel efficient methods. Dealers will have to play an important part in this change. They must help farmers in their equipment decisions. A big area will be matching tractors to implements.

Farmers will be looking at power tiller equipment in the future. Dealers should start looking at the demand in their area and make a decision on the profitability of carrying this type of equipment.

USE OF COMPUTER

Only fourteen percent of the farmers are currently using computer programs. Two reasons for farmers not using a computer are they feel their operations are too small and availability of a computer system. Farmers using a computer program feel it is beneficial to their operation.

Thirty-eight percent of the programs are provided through an extension service (Figure 15). Financial companies provide twenty-eight percent and equipment dealers provide three percent. Other special programs are provided through different associations: Angus Association, Dairy Herd Improvement Association, etc..

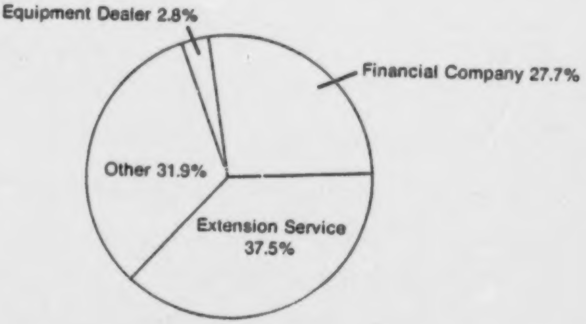

Figure 15 — Suppliers of Computer Programs

Computer programs in use, mainly deal with financial-type information. Of farmers using a computer program, seventy-one percent use a program for farm records, fifty-one percent use a program for profit/loss statements (Figure 16). Feed/nutrition schedules and fertilizer applications are two non-financial areas farmers are using computer programs.

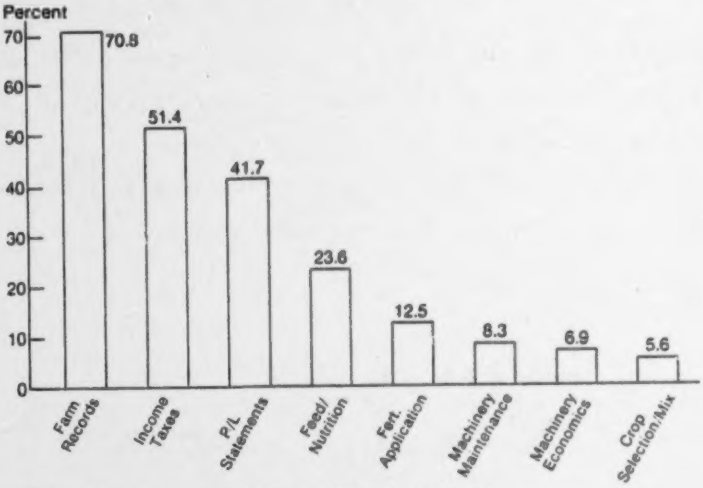

Figure 16 — Computer Programs Used by Farmers

Eighty-nine percent of the respondents feel farmers will be using a computer more in the future. However, only forty-five percent say they will themselves be using a computer in the future. A main reason is farmers feel their operations are too small. Once above the one hundred acre farm size, close to fifty percent of the farmers say they will use a computer in the future (Figure 17).

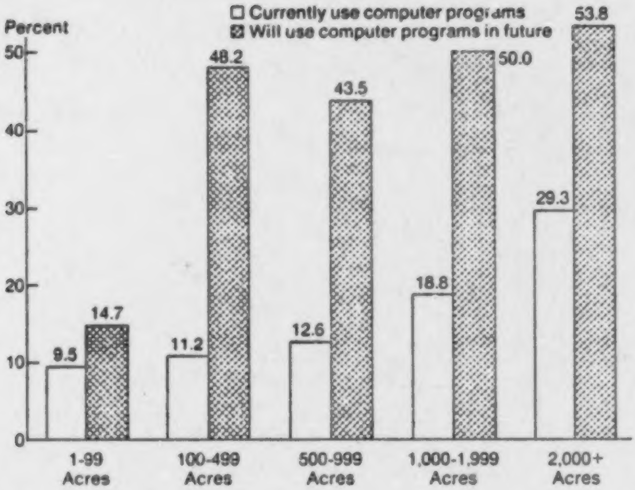

Figure 17 — Use of Computer Programs Now and in Future by Farm Size

In the future, as at present, farmers will be using computer programs dealing with financial information. Eighty-one percent of the farmers who say they will use the computer in the future will use it for farm records (Figure 18). Sixty-three percent will use a program for income taxes and fifty-four percent will use a program for profit/loss statements. In farm management information feed/nutrition schedules and fertilizer application rates will be used. Another growing area for computer programs is machinery economics.

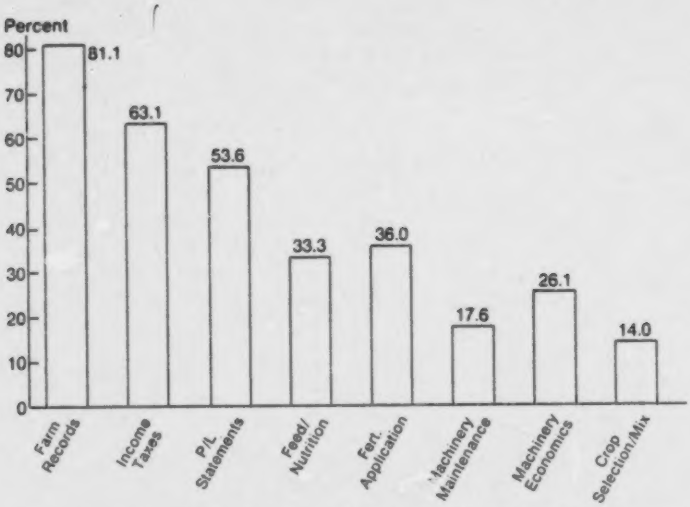

Figure 18 — Computer Programs Farmers Will Use in the Future

Looking at computer programs now and in the future as a percentage of all farmers, the computer area will be a growth market (Figure 19). This is true for both financial information and farm management information (fertilizer application, machinery economics, etc.).

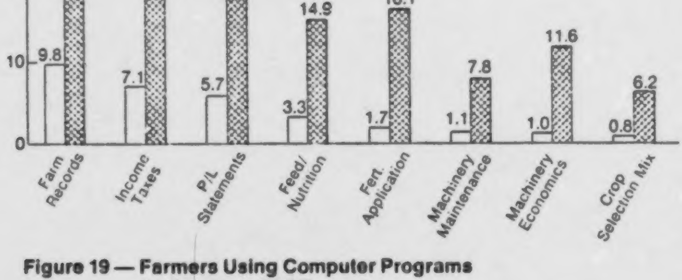

Figure 19 — Farmers Using Computer Programs As Percent of All Farmers

A large majority of the farmers feel mini-computers will be used on the farm within ten years (Figure 20). The average time is within eight years.

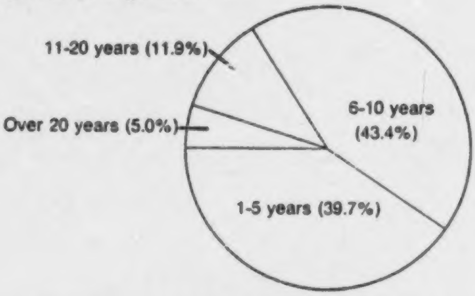

Figure 20 — Length of Time Before Minicomputers Will Be Used on Farms

IMPORTANCE FOR DEALERS

More and more farmers are going to use computer programs in their operations. Farmers are becoming more sophisticated and are trying to get the most out of their farms. Dealers must recognize this and work to stay ahead of them.

Farmers can get financial information from financial companies. They can get some management help from extension services. Then it is logical, they can get machinery help from equipment dealers. Shown in the preceding graphs, farmers are going to use computer programs to help them with machinery maintenance and economics. This may be an area dealers can help their customers.

It would be possible for dealers to offer computer programs dealing with machinery through access to their affiliate dealer association's computer system or their manufacturer's system. Dealers must keep up with the farmer's sophistication.

SEMINARS, NEWSLETTERS, AND FARM SHOWS

Farmers like the idea of a maintenance seminar after buying a new tractor. Eighty-six percent said they would attend a seminar to learn ways to maintain their machines.

Farmers will travel an average of forty-six miles to attend a maintenance seminar. Seventy-three percent of the farmers would travel more than twenty-five miles and twenty-six percent would travel over fifty miles to attend a maintenance seminar (Figure 21).

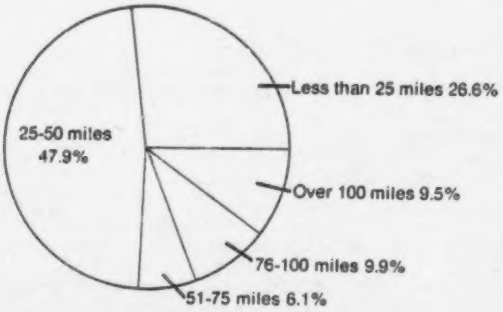

Figure 21 — Distance Farmers Will Travel to Attend a Maintenance Seminar

Farmers want to know about regular maintenance they can do themselves. Areas farmers want to see covered are:

	% OF FARMERS WHO WOULD ATTEND A MAINTENANCE SEMINAR
Regular maintenance	56
Maintenance on hydraulics and motors	13
Technical information	7
Proper operation under varying conditions	7

Eighty-two percent of the farmers receive one to five newsletters a month. The average number of newsletters received is four. The most helpful newsletters are:

	% OF FARMERS LISTING A NEWSLETTER
Doane's Report	32
Pro-Farmer	7
Kiplinger's	5
Extension service	4
Farm Bureau News	3
Farm Journal	3
Others	46

In a newsletter, farmers want to get information helping them make money from their operations:

	% OF FARMERS STATING TYPES OF INFORMATION
Price Forecasting	24
Marketing	20
New Equipment & Methods	12
Livestock and Crops	10
Weather	4
Management Techniques	3

Sixty-seven percent of the farmers regularly attend farm shows. Over sixty percent of the farmers who attend farm shows travel over fifty miles, with the average distance being one hundred and six miles (Figure 22).

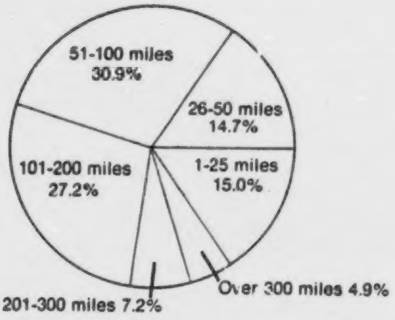

Figure 22 — Distance Farmers Travel to Attend Farm Shows

Farmers attend farm shows to see what is new in the industry. They want to see new machines, new methods, and new products.

The farm shows farmers attend are:

	% OF FARMERS WHO ATTEND FARM SHOWS
State Fairs	21
Farm Progress Show	17
National Farm Machinery Show	11
Farming Frontiers	8
Pennsylvania Farm Show	6
Farm Science Show	5

IMPORTANCE FOR DEALERS

Farmers are interested in doing regular maintenance on their machines. This can be good for the dealer, but it can also cause problems. If farmers do the regular maintenance, this leaves more time for the dealer to work on machines with major problems. However, if farmers do not know what they are doing on equipment they might cause more damage, making more work for dealers.

Holding a seminar to show your customers areas they can work on to keep their machines running in good condition is a good customer relations tool.

There are many different equipment models within a manufacturer's line. Each model may have a different maintenance procedure. A dealer may not sell enough machines in a certain model to justify holding a seminar for his customers. A possibility is to get two or three dealers selling the same line, together and hold a seminar for all the customers buying a particular model.

FARM LEGISLATION

Ninety-three percent of the farmers feel lobbying is beneficial to their operations.

American Farm Bureau Federation is the most widely recognized organization in lobbying for farm legislation:

	% OF FARMERS WHO KNOW ORGANIZATIONS - LOBBY FOR FARM LEGISLATION
American Farm Bureau Federation	82
National Cattlemen's Association	49
National Milk Producers	43
Farmers Union	42
National Farmers Organization	41
National Council of Farmer Cooperatives	26
National Association of Wheat Producers	25
Others	14

Other organizations mentioned in "Others" category were: National Pork Producers, National Grange, National Council of Agricultural Employers and National Cotton Council.

Taxes and profitable marketing of goods are areas farmers want in farm legislation:

	% OF FARMERS SPECIFYING AREAS FOR FARM LEGISLATION
Control of government regulations and trade limitations	17
Taxes	15
Stabilize grain prices	12
Return to free enterprise	8
Joint marketing effort with major exporting nations	8
Parity programs	5

IMPORTANCE FOR DEALERS

General farm legislation affects dealers in an indirect way. If farmers have more money to spend, either from profitable marketing of goods or tax advantages, they might spend more money on farm equipment. If farmers are prosperous so are farm equipment dealers. For this reason, dealers might want to be made aware of what is going on in farm legislation.

Affiliate and national associations can keep dealers aware of what is happening in general farm legislation. However, there are many other areas directly affecting dealers. The dealer trade associations should put their time and effort into these areas, leaving general farm legislation to other organizations.

FORECAST OF THE AGRICULTURAL ECONOMY AND EXPECTATIONS FOR THE 1980'S

I. Agri Economic Conditions for the Next 12 to 18 Months

In an aggregate sense, 1978 was a very good year for agriculture. Net farm income of $26.7 billion was 43% above the 1977 level. Not all segments of agriculture shared in this prosperity. Those involved in the animal sector were much better off than cash grain producers.

This year, 1979, has been an even better year. Price levels for cattle, corn, wheat, soybeans, and cotton have been above "year-ago" levels since January. Gross farm income for 1979 should be up 16%, with realized net farm income estimated at $34 billion, up 27% over 1979.

Farm Income — Billions of Dollars

	1977	1978	1979	1980
Realized gross	107.5	124.8	144.5	154.0
Production expenses	86.8	98.1	110.5	118.5
Realized net	18.7	26.7	34.0	35.5

Growth in the farm economy should continue into 1980. Gross farm income is estimated to be up another $10 billion, to $154 billion and net farm income could be in the $35 billion area.

It is not felt that the current recession will have a significant dampening effect on the agricultural economy. While lower levels of real disposable income and additional unemployment have negative effects on the demand for food, it is felt that the supply situation in agriculture and excellent worldwide demand will allow a favorable outlook for agriculture in the months ahead.

II. Economic Conditions for Agriculture into the 1980's

Assumptions for the general economy are that real GNP will show an average annual increase of 3.4% from 1980 to 1985 and an average annual increase of 3% from 1985 to 1990. This compares to a 2.8% annual growth rate from 1970 to 1980.

Annual Rates of Change (Percent)

	Real GNP	GNP Price Deflator
1960-70	3.8	2.9
1970-80	2.8	7.2
1980-85	3.4	7.0
1985-90	3.0	6.5

The inflation rate as measured by the GNP price deflator was assumed to increase during the first half of the 1980's at an annual rate of 7.0% and then abate some from 1985 to 1990 to an average increase of 6.5% per year. This compares to a 7.0% average annual increase during the 1970's.

Two series that reflect the agricultural price situation are the index of prices received and the index of prices received by farmers.

Annual Rates of Change (Percent)

	Producer Prices	Prices Received by Farmers	Prices Paid by Farmers
1960-1970	.8	1.6	2.7
1970-1980	8.1	8.5	8.8
1980-1985	7.2	5.8	6.9
1985-1990	6.8	7.2	7.4

During the next decade, it is estimated that prices received by farmers will about equal the general price level or inflation rate. From 1980 to 1985, prices received by farmers may increase at a slower rate than the overall producer price index (formerly wholesale price index). However, from 1985 to 1990, we should see demand for food and agricultural production exceeding supply on a more frequent basis even with increased productivity.

Estimates of agricultural commodity prices and farm income for 1985 are illustrated in the following charts.

U.S. Average Prices Received by Farmers
Calendar Year

	1979	1980	1985
Corn $/bu	2.35	2.50	3.50
Wheat $/bu	3.40	3.75	5.00
Beans $/bu	6.90	6.80	8.50
Cotton ¢/lb	55	58	78
Cattle $/cwt	65	68	75
Hogs $/cwt	40	43	55

Farm Income — Billions of Dollars

	1979	1980	1985
Realized gross	144.5	154.0	222.0
Production expenses	110.5	118.5	178.0
Realized net	34.0	35.5	44.0

III. The Structure of Farming in the 1980's

The number of farms in the United States is expected to decline during the next decade, however at a slower rate than in the 1960's and 1970's. Estimates put the number of farms in 1985 at 2.5 million, compared to 2.7 million farms in 1977.

In 1977, 162,000 farms of the 2.7 million farms grossed over $100,000 in sales of farm products. These 6% of the farms accounted for 53% of the sales of farm products.

In 1985, there are expected to be at least 300,000 farms grossing over $100,000 a year in sales of farm products. This means 12% of the farms will account for 66% of the sales of farm products in 1985.

Editors and economists in the Publication Division of Doane Agricultural Service, Inc. were asked to list trends or developments that they feel will be emerging in the 1980's. The following summarizes their thoughts.

1. Increased emphasis by the Federal government on preserving our nation's water quality, combined with farmers' attempts to reduce energy use and costs, will contribute to an increased use of reduced or no-tillage practices. On lands susceptible to erosion, it can permit more intensive cropping while maintaining acceptable standards of water quality.

2. We will see more farm buildings designed and constructed with solar collectors to provide partial energy requirements for crop drying and heating livestock and machinery shops. More use will be made by livestock producers of high moisture grain to avoid drying.

3. Chemical usage will continue to be under close scrutiny by the EPA. Likewise, farmers will become more concerned about getting their money's worth from their use. This will lead to increased use of integrated pest management, which allows the grower to more closely zero in on when usage will pay and when returns will exceed the cost.

4. More emphasis will be given to production and breeding of crops for the twofold purpose of producing grain and using the by-product (residue or bio-mass) for producing energy. We are seeing an increased interest by farmers, not only in gasohol, but also in on-farm stills, hoping to make their farms energy self-sufficient.

5. The whole energy problem could induce some of the most dramatic changes in this century for agriculture. This could occur not only on the farm, but throughout the marketing chain, in transportation, in processing, and even how foods are displayed in supermarkets.

6. Soaring energy costs could produce a change from the recent trend toward more confined environmental controlled buildings in hog production. Cheaper, smaller, more labor intensive facilities might then become relatively more competitive. If this occurs, it would then imply that the growth of large corporate hog facilities will not proliferate as has been assumed in recent years.

7. The energy and fertilizer value of animal waste will also take on increased importance. Methods of converting these wastes to fuel or efficiently utilizing them as fertilizer will receive much more attention.

8. There will be activity in the field of animal drugs. Several drugs appear to be scheduled for withdrawal from markets, while others are "waiting in the wings" to receive the same treatment. The loss of these drugs will force adjustment bv the livestock industry. At the same time, new drugs have appeared on the market and have shown considerable promise.

9. Pressures and increased costs of farming will necessitate improved record keeping and profitability analysis. Alternatives will have to be analyzed quantitatively to determine the profitability of each. Increased usage of micro-computers will be needed to give accurate data storage, retrievable, and analysis.

Senator D'Amato. We stand in adjournment. I thank you for your participation.

[Whereupon, at 1:25 p.m., the committee recessed, to reconvene at the call of the Chair.]

APPENDIX

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

HILTON DAVIS
VICE PRESIDENT
LEGISLATIVE AND POLITICAL AFFAIRS

1615 H STREET, N.W.
WASHINGTON, D. C. 20062
202/659-6140

COPY

March 5, 1982

The Honorable Lowell P. Weicker, Jr.
Chairman
Small Business Committee
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

This letter is in regard to your recent hearings on the Safe Harbor Leasing Provisions of the Economic Recovery Tax Act of 1982 (ERTA).

On February 18, 1982, the U.S. Chamber's Board of Directors approved the attached legislative proposals which constitute our Small Business Tax Program. We believe that this program provides a comprehensive approach to tax changes of benefit to small business.

Item #10 recommends that the safe harbor leasing provisions contained in ERTA be broadened to allow closely held businesses to participate as lessors without the application of Section 465 "at-risk" rules. Section 465 restricts the amount of depreciation deductions and investment tax credit which a taxpayer may claim to the amount the taxpayer has "at risk" in the form of equity and recourse financing.

Since safe harbor leases generally depend on nonrecourse financing, Section 465 not only effectively restricts the availability of the safe harbor leasing provisions for closely held small businesses (companies in which 50 percent of the value of outstanding stock is owned directly or indirectly by not more than five individuals), but also discriminates against small businesses by not allowing them to make use of the leasing provisions which are available to larger corporations. This inequity should be corrected.

One of the major problems facing smaller firms today is the cost of debt financing. Leasing is an attractive way to finance needed capital expansion. Although leasing is not now being extensively used by small business, we expect this will change as more brokers begin to focus on this rather large potential market. According to the 1976 Statistics of Income, companies with less than $100,000 in total assets comprise 48.7 percent of all corporations with net income, while this same category constitutes over 71 percent of all corporations without net income. As more leasing transactions are accomplished, the transaction costs will decrease and the ability to "pool" potential lessors and lessees will increase. Many of these small companies with losses will find leasing to be a viable alternative to more traditional financing methods.

Safe harbor leasing is an important part of the Accelerated Cost Recovery System. It helps assure that the entire economy will be stimulated without encouraging unsound investments made strictly as tax shelters, and it substantially reduces the complexity and uncertainty embodied under the old leasing rules. For these reasons we support changes to allow full participation by the small business community.

We will appreciate your considering our views and request that this letter be made a part of the hearings record.

Cordially,

Hilton Davis

Hilton Davis

cc: Committee Members
Robert Dotchin, Staff Director
Alan Chvotkin, Chief Minority Counsel

Attachment

Small Business Tax Program

1. Corporate Rates
   Reduce corporate rates on the first $500,000 of taxable income.

2. Capital Gains
   The effective rate of tax and capital gains should be reduced in order to increase the availability of investment capital.

3. Investment Tax Credit For Used Equipment
   The annual limitation for investment in used qualifying property for purposes of the investment tax credit should be increased to at least $250,000. (Prior Board Statement set amount at $200,000)

4. LIFO Recapture
   Repeal the LIFO Recapture Provision (Section 403(b) of the Windfall Profit Tax Act). (The Tax Committee approved this position October 1, 1981)

5. Inventory Simplification
   Further simplify the tax accounting for inventories by allowing a single pool of goods for small business and the use of exogenous indexes. (New)

6. Minimum Accumulated Earnings
   The minimum credit for earnings which may accumulated before any accumulated earnings tax would apply should be increased to at least $500,000. (Same as prior Board Statement.)

7. Subchapter S Corporations
   Revise the Subchapter S provisions to make their use more widely available to small business, by, among other changes, increasing the maximum number of Subchapter S shareholders and expanding the categories of eligible shareholders. (Same as prior Board Statement)

8. Closely Held Business Rollover
   Permit the Owners of a closely held business to defer tax on the sale of the equity of the business if the proceeds are reinvested within a specific time in other small business investments.

9. Independent Contractors
   A safe harbor provision should apply to individuals historically treated as independent contractors and a withholding tax should not be required. (Position adopted by the Board June 21, 1979)

Adopted by the Board of Directors, Chamber of Commerce of the U.S.
February 18, 1982

10. Leasing

    The safe harbor leasing provisions contained in the Economic Recovery Tax Act of 1981 should be broadened to allow closely held businesses to participate as lessors without the application of the Section 465 at-risk rules. (New)

11. Debt-Equity

    The debt-equity rules issued pursuant to Section 385 should be written to enable smaller firms to easily comply with the law. (New)

12. DISC

    Tax incentives such as DISC should be preserved and enhanced in order to foster small business exports. (New)

Statement of Jonathon O. Moore

Before the Committee on
Small Business
United States Senate

Good morning. My name is Jonathon Moore, and I am president of Air U.S., a small commuter airline serving communities in Colorado and Wyoming. Air U.S. currently operates five commuter planes, one of which was acquired last year in a transaction involving a safe-harbor lease. We hope to add one additional plane this April and another by early fall. Whether or not we are able to continue our expansion will, to a large extent, depend on whether safe harbor leasing is available.

Introduction

I commend the Committee for its decision to review the impact of the safe-harbor leasing provisions. A key factor that Congress must analyze is the value of these provisions to businesses which do not make the *Fortune* 500 ranking. As other witnesses have indicated to you, the recentness of the legislation, and the fact that most information to date relates to the retroactive effect of the legislation may give a distorted and understated view of the significance of safe-harbor leasing to small business. In spite of this, however, the Treasury has submitted data which reflects the very significant use of safe harbor leasing by small business. I believe it is clear that small business is using safe harbor leasing, and that the proportion of safe harbor leases by small business will continue to grow as the transactions become standardized.

Other witnesses have testified today regarding some of the impediments to the use of safe harbor leasing by small business, for example, the recapture rules in the case of lessee insolvency. I am sure you will find their testimony useful and interesting. However, in my testimony today, I would like to focus my remarks on sharing with you the enthusiasm we feel for safe harbor leasing, the future plans we have involving safe harbor leasing, and what is the biggest impediment - a nonstatutory impediment - facing us today.

Who Benefits from Safe Harbor Leasing?

Air U.S. is one small business that has and will benefit from the Economic Recovery Tax Act's safe harbor leasing provisions. Air U.S. has planned to purchase at least two new airplanes during the remainder of 1982. These planes would be used to initiate and improve service to communities in Wyoming, Colorado, and (hopefully) other Western States. Not only will this expansion improve service to Essential Air Service locations, it will also result in the creation of 250 permanent, high quality jobs. With financial markets in disarray and the economy in a recessionary state, this expansion would be impossible without the benefits of safe-harbor leasing.

The ability of Air U.S., and small businesses in general, to transfer tax benefits is an essential method of financing in the current economic climate. Indeed, because financing is, even in the best of times, more problematical for small businesses than for large long-established concerns, safe harbor leasing has an especially important role for the small corporation and the small entrepreneur. In addition, the commuter airline industry makes significant use of the Federal Aviation Administration's Aircraft Purchase Loan Guarantee Program, guarantees which could not be used in conjunction with traditional sale-leaseback techniques. But FAA loan guarantees are available for safe harbor leasing transactions, and they are being used.

The Threat of Repeal

As you can see, safe harbor leasing is of tremendous value to small commuter air carriers like Air U.S. Nonetheless, a shadow has been cast over safe harbor leasing recently, and this shadow threatens to undermine our plans for expansion and improvement of service. Senator Dole has announced that he will seek the repeal of safe harbor leasing retroactively to February 19, 1982. It is unlikely that Congress will actually deal with this proposal until

May, but in the meantime his comments have removed the certainty from transactions that demand certainty. Distressingly, Senator Dole's announcement amounts to a change in our tax law by individual fiat, since the in terrorem effect of the announcement has caused a general cessation of lease activity. It will, as you might expect, be difficult to move ahead with our airplane acquisition program because of this announcement. I urge this Committee to do whatever it can to preserve and improve safe harbor leasing. The first step is, I suggest, to call for the prompt retraction, or at least clarification, of Senator Dole's proposal. If Senator Dole's goal is really some reasonable limitation of safe harbor leasing, a specific proposal should be made as soon as possible, so that the current economically harmful uncertainty and general freeze on leasing may end.

By way of conclusion, I would like to note that the "safe harbor" leasing provisions were the bright spot in the Economic Recovery Tax Act for the badly depressed commuter airline industry. After decades of regulation, airline deregulation has resulted in an extraordinary and volatile situation in the airline industry. It is a condition which demands the highest efficiency possible. Safe-harbor leasing meets this demand. It continues the progress of deregulation by allowing small airlines, such as Air U.S., to expand, adapt, and improve their efficiency. I strongly urge you to help continue its benefits.

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